



HOW TO WRITE A CONTRACT THAT WILL LIMIT DAMAGES FOR IP VIOLATIONS

By: Jim Astrachan

Last month I was representing the defendant in a settlement conference before a United States magistrate. The defendant had been served with a shotgun complaint alleging, among other wrongs, breach of contract, tortious interference with business opportunity, theft of trade secrets, and copyright and trademark infringement.

The springboard for the parties' hard feelings was their written contract for the defendant to develop software for the plaintiff. The plaintiff had the impression that the defendant, having performed its job admirably, had then purloined the software for sale to others, in competition with the plaintiff. Of course the defendant disputed the claim, but the prospect of protracted and very expensive litigation caused the defendant to seek legitimate ways to limit its potential exposure.

One limitation was found in the contract itself which read, liability "...shall not exceed the aggregate amount paid by the non-breaching party to the other under this contract." Through its copyright claims alone plaintiff sought millions of defendant's profits attributable to the infringement and its own damages that it claimed were not duplicative of defendant's

profits. Not to mention the punitive damages for tort and the trebling of damages under the Maryland Uniform Trade Secrets Act.

The case settled and the defendant survived, perhaps in part due to the existence of this limitation of damage clause raised as a bar to excessive recovery. But would this clause have survived careful judicial scrutiny and served to really limit damages? Maybe not this one. But a limitation clause can be properly drafted to avoid these damages.

This is not an issue found in your common garden, or often dealt with by the courts. In fact, cases where this issue has arisen are scant. In one unreported case, however, the parties contracted for the conversion of software and the vendor's contract wisely contained an expressed limitation of liability, not unlike the one I dealt with. In it, the vendor limited its liability to one-half the fees paid to it in the six months preceding notice of the breach of contract. The vendor did a fine job of conversion, in fact so fine, that after it completed its task it recognized it had a successful commercial product in its hands, albeit one that it did not own. Exercising entrepreneurial chutzpah it began to license its customer's software to third parties, making a mint in the process. When the customer emerged from the coma caused by the shock of learning what its trusted vendor had done it sued for theft of trade secrets and copyright infringement.

There was absolutely no question that the vendor had infringed its customer's copyright by reproducing and distributing its software without authority. But the vendor claimed that the expression of damage limitations contained in the contract provided a maximum liability and

that its former customer could not recover the many millions of dollars in profits the vendor had improperly earned, as was the customer's remedy under the Copyright Act.

The court carefully examined the contract, the parties' conduct and the nature of the damages. Then it set out to parse the defendant's complained-of acts into the two potential categories: violations of the independent contractual covenants, such as failing to timely deliver product, or meet conversion standards, and violations, in this case, of the actual scope of the license whereby the defendant was allowed access to the software to enable it to perform conversion.

The court ruled that the violation of an independent contractual covenant sounds only in contract. So if the defendant had tried, but failed, to convert the software and as a result of the failure, the plaintiff's business was bankrupted, the limitations of damages would be enforceable. Instead, the violation of the scope of the license resulted in the infringement of the plaintiff's intellectual property rights, and thus the Copyright Act. In essence, can the license agreement preempt federal law? Does contract construction require division of sources of damage and a determination of whether the parties contracted away their rights under copyright law?

The court determined that it was proper to interpret the language contained in this limitation clause to apply only to damages suffered as a result of the breach of an independent contractual covenant, such as warranty of functionality, timely delivery or compatibility. But the limitations clause cannot apply to damages arising from infringement of the customer's copyright or theft of its trade secrets.

Often, limitation of damages clauses are more muddled than these and raise more questions than they answer. For example, the parties may seek to limit damages for acts "related to, or arising out of" the contract. Huh?

But there is no prohibition found in the copyright trade secret or contract law that prevents two commercial parties of equal bargaining strength from contracting away all or some of their remedies if they are damaged by an act, or failure, of the other party. At least one court has recognized that a contract clause could be designed to establish a damages ceiling regardless of whether the damage is caused by infringement of intellectual property rights or violation of contract. But where the clause neglects to mention damages arising under copyright law for infringement, the clause will be construed to limit only those damages arising from breach of the contract.

It follows, then, that any person drafting a limitation of damages clause should consider extending the scope to include within its confines, more than mere breach of the underlying contract. This is especially true between commercial entities of equal bargaining power where a court is unlikely to find expressions of limitations unconscionable.

I would suggest the following, although I want no service of process if it fails:

"Under no circumstances shall Vendor's liability for acts, or failure to act, including liability for breach of contract, tort, copyright infringement, theft of trade secrets, or any

other violation of intellectual property rights exceed in the aggregate the money paid by Customer to Vendor."

At the very least, when threatened with suit for breach or infringement of intellectual property rights, this clause becomes a formidable hurdle to clear before recovery of excessive damages can occur, and will serve as a sobering incentive to reach a settlement prior to the commencement of litigation.

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