



Issue Brief

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Walking the Road to the Win-Win: NASCIO Procurement Subcommittee's Recommendations on Liability Limitations for State IT Contracting

This document is intended to provide recommendations from NASCIO's Procurement Subcommittee regarding liability limitations that are included in state IT contracts. In spring 2004, the Procurement Subcommittee conducted a survey of NASCIO state and corporate members regarding their approaches to certain IT contract terms, including liability limitations, intellectual property, warranties, liquidated damages, and most favored nation clauses. Section I includes the Procurement Subcommittee's general findings on liability limitations. Section II provides the Subcommittee's recommendations for state IT contracting to help bring states and vendors closer to IT contracts that are "win-win" for both parties to the contract.

I. Summary of Procurement Survey Results

State Standards for Liability Limitations—Overview of Survey Results

- **Number of versions:** From both the corporate and state perspectives, there was an almost even split, with half of the respondents indicating there is only a single version of the clause and half indicating the existence of multiple versions.
- **Whether mandatory:** A majority of both corporate and state respondents indicated that this is a mandatory clause. It was viewed as mandatory to a greater extent in the private sector.
- **Origin of clause:** There appeared to be a variety of origins of this clause. They included an origin in statute and marketplace negotiations.
- **Prevalence in various types of contracts:** For both the corporate and state respondents, this clause is prevalent in almost all types of contracts.

Effect of State Standard Clauses for Liability Limitations—Overview of Survey Results

- **Whether reduced competition:** A vast majority of corporate respondents indicated that this clause reduces competition. A 6-5 majority of state respondents indicated no effect on competition.
- **Whether price difference:** Again, a vast majority of corporate respondents indicated that this clause results in a price difference. A 4-3 majority of state respondents indicated that there was no price difference.

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- **Commercial norm:** Most states and corporations indicated that a liability limitation is the commercial norm. Most states indicated that the commercial norm for the amount of the limit is the value of all payments under the contract. However, a majority of corporations indicated that the limit is the value of the disputed deliverable.
- **State standard:** A majority of state and corporate respondents indicated that the state standard is no liability limitation.

II. Recommendations

General Recommendations:

As a general principle, the Procurement Subcommittee recommends that both states and vendors work to determine the true risks that are associated with state IT procurement contracts and then allow the states to protect themselves against those true risks, as opposed to drafting IT contracts with unlimited liability for IT vendors. This approach is intended to improve competition for state IT contracts and is expected to result in higher quality vendor products and services at a lower cost to the states.

While the recommendations below examine ways to reduce risk and increase the likelihood of “win-win” contracts for states and vendors, it is important to remember that the best way to limit risk in IT procurements is through good contract scoping, specifications, management and administration. Such aspects are vital to successful outcomes for state IT procurements and their value should be considered in addition to the recommendations set out below.

A Word About State Legal Requirements & Consulting with Legal Counsel:

Since procurement and other legal requirements vary greatly from state-to-state, there is the possibility that implementation of one or more of the recommendations below could conflict with a state’s legal requirements. In order to identify and properly address any potential conflicts, the Subcommittee encourages state CIOs and others to fully research their state’s legal requirements regarding procurement and consult with their state attorney general or other appropriate legal counsel if considering the implementation of one or more of the Subcommittee’s recommendations.

A Word About Types of Liability Claims and Damages:

State IT contracts typically address the types of claims for which a vendor might be held liable. Legal claims can arise from many sources including:

- From the contract itself
- From a warranty that the vendor either explicitly or implicitly made to the state
- From state or federal laws that address tort liability or strict liability
- From federal laws on intellectual property ownership and use.

States may consider addressing in their IT contracts the types of claims for which a vendor might be held liable.

Regarding liability lawsuits, the party found to be responsible commonly is obligated to pay the other party damages. There are many types of damages that might be included within a judgment that a responsible party might pay. They can range from direct damages, which typically are to compensate the injured party “for a loss that is an immediate, natural, and foreseeable result of the wrongful act.” However, in some cases, depending upon the jurisdiction in which the lawsuit is brought and the contract language, a responsible party might have to pay indirect damages, which is a category of damages that can be in addition to direct damages. Below, please find a list of types of indirect damages and definitions for each. These may be helpful during the contract negotiation phase in deciding which types of indirect damages might be included in a vendor’s potential liability.

- **Special or Consequential Damages:** “Damages awarded in an amount deemed to compensate for losses that arise not as a natural result of the injury but because of some particular circumstance of the injured party” or “damages relating to a business, profession, or property that are easily calculable in monetary terms.”
- **Incidental Damages:** “Damages recoverable under section 2-715 of the Uniform Commercial Code in breach of contract cases for losses that include expenses incurred in handling and caring for goods which were the subject of the contract, reasonable expenses incurred in obtaining cover, and any other reasonable expenses resulting from the breach that do not fall into any other category.”
- **Punitive or Exemplary Damages:** “Damages awarded in cases of serious or malicious wrongdoing to punish or deter the wrongdoer or deter others from behaving similarly.”

These and other definitions are available at <http://dictionary.lp.findlaw.com/>.

Note that a contract also might specify whether a vendor will be liable for lost profits, revenue, operating savings, goodwill, reasonable attorneys’ fees, or taxes incurred.

The following resources may be helpful in gaining additional insight into the intricacies of liability limitations within the context of contracts law:

- For more detailed information about general contract law principles, please see the Restatement of Law Second, Contracts. Information on this Restatement is available through the American Law Institute at: <<http://www.ali.org/>>.
- For additional information pertaining to commercial law, including the sale of goods, please see the Uniform Commercial Code (UCC) at the American Law Institute’s website at: <<http://www.ali.org/>>.
- For more specific information about transactions involving computer information, please see the Uniform Computer Information Transactions Act (UCITA) at: <http://www.law.upenn.edu/bll/ulc/ulc_frame.htm>.

Specific Recommendations:

Liability for Direct and Indirect Damages:

- States should hold vendors responsible for direct damages arising out of a state IT contract.
- States should not hold vendors responsible for third party claims arising out of indirect damages. *[Subcommittee Note: The Subcommittee encourages states to fully research their legal requirements to ensure that the implementation of this recommendation would not conflict with existing legal requirements. Issues pertaining to whether vendors should be responsible for these types of claims should be identified up-front in a state's solicitation or during contract negotiations to ensure that such issues are addressed fairly and resolved prior to contract execution.]*
- Unless responsibility is specifically allocated to the vendor in the contract, the state should not hold vendors responsible for indirect damages, including special or consequential damages. For example, the vendor should not be liable for lost data, unless the contract provides for vendor responsibility for lost data in the contract. *[Subcommittee Note: From a technical standpoint, the Subcommittee recognizes that state IT contracts may contain a general disclaimer of vendor liability. In such contracts, exceptions providing for vendor liability for certain types of damages, including liability for indirect damages, would be listed in the contract.]*

The Amount of Liability Limitations:

- Vendor liability should be limited according to the risk associated with the contract. Opinion varies as to the generally accepted amount of liability in relation to the value of the contract, although two times the value of the contract appears to be a high end amount. However, liability limitations in excess of two times the amount of the contract could be warranted for high-risk contracts, such as contracts for state IT systems that involve public safety or homeland security.
- If a contract contains a liability limitation that is a multiple of the total amount of the contract, then the state and vendor should specifically address in the IT contract how the "amount of the contract" should be calculated. This is especially important where a contract has an extension clause that could extend the term of the contract or other type of unique funding mechanism (for example, where the contract is a multi-year contract but is only funded for a portion of the contract's term).

Copyright and Patent Claims:

- States should not cap a vendor's liability for copyright or patent lawsuits.

Death or Bodily Injury Suits:

- States should not cap a vendor's liability for death and bodily injury lawsuits.

Sovereign Immunity:

- States may not have the ability to waive their sovereign immunity rights, because they are constitutional and/or statutory rights to protect the government as well as the citizenry. States are encouraged to consult with their legal counsel to determine their individual state sovereign immunity requirements and whether they have any flexibility to waive those rights.

What CIOs Need to Know

Both states and vendors should work to determine the true risks associated with state IT procurement contracts and then allow the states to protect themselves against those true risks, as opposed to drafting IT contracts with unlimited liability for vendors.

States should identify and address any issues related to liability limitations early in the contracting process to ensure that the issues are resolved prior to contract execution.

States should consult with their legal counsel early in contract negotiations to identify and address legal issues of concern.

Good contract scoping, specifications, management and administration are the best ways to reduce the overall risk associated with state IT contracts.