

Contractual Applications of Negligence/ Gross Negligence Standards: Considerations Under New York Law

By **David Shine**

Contract negotiations involving indemnities and releases often include intense debate as to whether a released or indemnified party should lose its protection in the event of its “negligence” or, alternatively, in the event of its “gross negligence.”

Given this high threshold for gross negligence, before allowing it as an applicable standard of conduct, a party should carefully consider the types of behavior that would not violate a gross negligence standard and whether this standard then makes sense in the context of the proposed transaction.

When pressed as to the real difference between these standards, corporate lawyers may be of the view that the difference is merely a matter of degree, akin to the difference between “a fool and a damn fool.” But under New York law, gross negligence is more than just heightened negligence. Rather, it is closer to willful misconduct, and thus, it is different in kind, not just degree. Furthermore, under New York law, releases from gross negligence are generally not enforceable anyway, and so an exception for gross negligence in the context of a release may not be as critical a contract point as parties may perceive. On the other hand, indemnification which protects a party from third-party claims even in the event of the party’s own gross negligence may be enforceable and thus worthy of debate. Any contract negotiation regarding negligence or gross negligence exceptions to releases or indemnities should be informed by these considerations.

Contractual Contexts

The negligence/gross negligence debate may arise in several contractual contexts. In a private company acquisition agreement, officers and directors of a target may argue that a buyer’s only post-closing remedies should be for breaches of representations and warranties or for expressly retained liabilities. The officers and directors may therefore seek releases from claims that could be brought against them as individu-

als after the closing based on their pre-closing conduct. Even if a buyer were willing to grant such a release, it will likely argue that the release should not apply to conduct that constituted “bad acts” of the released individuals. The central debate then is often whether this exception should apply to negligent acts or only in the event of grossly negligent acts.

[T]he court noted that gross negligence differs “in kind, not only degree, from claims of ordinary negligence” and that gross negligence is “conduct that evinces a reckless disregard for the rights of others or ‘smacks’ of intentional wrongdoing.”

The negligence/gross negligence debate also occurs in the context of service agreements. Following a sale of a subsidiary, a parent company may agree to provide interim services post-closing to the buyer until the buyer is able to fully transition the acquisition. Since a seller may view the provision of these types of services as an accommodation to the buyer (and may, in fact, provide the services at cost), the seller may seek indemnities and exculpation from liability with respect to the services provided. Whether there should be exceptions to the seller’s protection in the event the seller is negligent or grossly negligent in providing the services may then be the subject of negotiation. Engagement letters for investment banking services always include indemnities and exculpations from liability. These provisions are generally viewed by the investment banks as non-negotiable and the applicable exceptions are almost always for gross negligence of the bank rather than mere negligence.

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Joint venture agreements often include provisions that allow a general partner or a managing member to seek indemnification for liabilities it may be subject to as a result of its activities on behalf of the venture, and related exculpation. In this context also, the parties may debate whether such protection is appropriate with respect to acts that constitute negligence or gross negligence.

[P]arties should keep in mind that releases from gross negligence are likely not enforceable in New York in any event.

And the Michael Ovitz/Disney¹ case prominently illustrates the importance of understanding gross negligence in a contractual context. There, Michael Ovitz's contract permitted Disney to terminate him without payment of the \$140 million severance in the event Ovitz had been grossly negligent in the performance of his duties. The contract did not define gross negligence but Disney's general counsel reportedly concluded that based on "dealing with contracts all [his] life" he instinctively knew that Ovitz's conduct did not rise to the level of gross negligence.

Gross Negligence under New York Law

Meaning of Gross Negligence—Although in practice parties may believe that negligence is a form of mistake or error and that gross negligence is a particularly egregious example of negligence, the New York cases support a different view.

In *Sommers v. Federal Signal*,² a fire alarm company failed to immediately report a fire signal it received from a 42-story building due to confusion on the part of the employee on duty. The alarm company's contract provided that it would have no liability to its customers in the event of the alarm company's negligence. As discussed below, the Court of Appeals noted that such a contract provision would be enforceable with respect to negligence but not with respect to gross negligence. And so the Court went on to articulate the legal standard for gross negligence. The court said that gross negligence, when invoked to pierce an agreed-upon limitation of liability in a commercial contract must "smack of intentional wrongdoing" and that it is conduct that evinces a "reckless indifference to the rights of others."

A later Court of Appeals case addressing this issue is *Colnaghi, USA Ltd. v. Jewelers Protection Services, Ltd.*³ In *Colnaghi*, an art gallery owner and the owner of two paintings consigned to the gallery brought an action against the company that had installed the

gallery's alarm system after burglars broke in through a skylight and stole numerous paintings. The contract pursuant to which the alarm system had been installed absolved the alarm company for any liability for its negligence. The New York Court of Appeals held that the alarm company's failure to wire the skylight did not rise to the level necessary to abrogate the gallery's agreement to absolve the alarm company for its negligence. In *Colnaghi* the court noted that gross negligence differs "in kind, not only degree, from claims of ordinary negligence" and that gross negligence is "conduct that evinces a reckless disregard for the rights of others or 'smacks' of intentional wrongdoing."

While not completely certain, New York law does, however, appear to support the enforceability of contractual indemnification with respect to acts that might constitute gross negligence.

Enforceability of Gross Negligence Exceptions—

Although the New York courts have articulated the meaning of gross negligence, use of a gross negligence standard is not enforceable in all contexts. New York law provides that a party may insulate itself from damages in the event of its negligence but that a party may not insulate itself from damages caused by its gross negligence.⁴ This applies equally to contract clauses purporting to exonerate a party from liability and clauses limiting damages to a nominal sum.⁵ The negligence/gross negligence debate in the context of exceptions to releases from liability may therefore be of limited utility. Since a party may not, under New York law, obtain a release from liability for acts that constitute gross negligence, a clause that provides a party with a release from liability "except to the extent of its gross negligence" does not offer the releasing party any more protection than it would already be entitled to under New York law. Granted there would likely be a benefit to having an express contractual agreement on this issue rather than having to rely on applicable law, but parties should nevertheless be cognizant of the limited added benefit of such an exception.

It is less clear under New York law whether a party may seek contractual indemnity in a situation where the party was grossly negligent. In *Austro v. Niagara Mohawk Power*,⁶ a power company, as the defendant in a personal injury action, sought indemnity from the third-party defendant construction company under terms of the construction contract by which the

construction company agreed to indemnify the power company for liability caused by the power company's negligence arising out of the construction work. The court permitted the power company's claim despite the jury's finding that 75% of the power company's negligence was gross negligence. There the court held that indemnity contracts that shift the source of compensation without restricting the injured party's ability to recover are unenforceable, as violative of public policy, only to the extent that they purport to indemnify a party for damages flowing from the "intentional causation of injury."

But despite the Court of Appeal's apparent recognition in the *Austro* decision of the enforceability of an agreement indemnifying against the indemnitee's gross negligence, several lower courts have concluded that an indemnity provision is void to the extent that it insulates the indemnitee from liability for its own gross negligence.⁷

Conclusion

Parties should be acutely aware of the vast difference between the New York court's standard for negligence and the standard for gross negligence. Gross negligence is not simply an egregious form of negligence. Rather, it is akin to intentional wrongdoing. Given this high threshold for gross negligence,

before allowing it as an applicable standard of conduct, a party should carefully consider the types of behavior that would not violate a gross negligence standard and whether this standard then makes sense in the context of the proposed transaction.

Also, before spending negotiating capital on whether a party should be released for acts that might constitute gross negligence, parties should keep in mind that releases from gross negligence are likely not enforceable in New York in any event. While not completely certain, New York law does, however, appear to support the enforceability of contractual indemnification with respect to acts that might constitute gross negligence. The negligence/gross negligence debate should therefore continue to be important in this context.

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- 1 *In re The Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003).
- 2 *Sommers v. Federal Signal Corp.*, 79 N.Y.2d 540.
- 3 *Colnaghi, USA Ltd. v. Jewelers Protection Services, Ltd.*, 81 N.Y.2d 821 (1993).
- 4 *Kalisch-Jarcho, Inc. v. City of New York*, 58 N.Y.2d 377.
- 5 *Sommers*, *ibid.*
- 6 *Austro v. Niagara Mohawk Power Corp.*, 66 N.Y. 2d 674.
- 7 See *Idone v. Pioneer Sav. and Loan Ass'n*, 159 A.D.2d 560, 552 N.Y.S.2d 424 (2d Dep't 1990); *Grand Manor Health Related Facility v. Hamilton Equities, Inc.*, 147 A.D.2d 118, 541 N.Y.S.2d 425 (1st Dep't 1989).

Correction

In the chart of "Leading Announced International M&A Deals, 2005" on page 3 of the March issue of *The M&A Lawyer*, the firm of Wachtell, Lipton, Rosen & Katz was inadvertently left off the list of legal advisors to Novartis AG, in its acquisition of Hexal AG of Germany. *The M&A Lawyer* regrets the omission.