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CONTRACT DRAFTING TO REDUCE OR ELIMINATE DAMAGES – WHAT ARE THE LIMITS?

LIMITATIONS ON CLAIMS AND LIABILITY

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Contract Drafting to Reduce or Eliminate Damages – What are the Limits?

Limitations On Claims and Liability

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Picture it: Your design professional client calls you in a panic upon being threatened with a $100 million claim for negligence. The designer provided a total of merely $5,000 in services on this particular project and is worried he could now lose everything. But you're not worried. With your expert negotiation skills and superior drafting, you secured a limitation of liability clause in your client's contract before the Project began, which capped his liability at $5,000 -- the amount of fee his was paid on the Project. But will such a clause really survive judicial scrutiny? Will it really protect your client?

Clauses in construction contracts that (1) limit liability to certain claims; (2) limit liability to fees paid; and (3) limit liability to insurance recovery are indeed important tools to use to protect clients. By negotiating and drafting an enforceable limitation of liability clause, a design professional or subcontractor, for example, can avoid being dragged into unnecessary and

potentially costly litigation. This section of the article will focus on examples of jurisdictions that have upheld the enforceability of limitation of liability clauses, and the critical guidelines to follow when negotiating and drafting a limitation of liability clause.

Enforceability of Clauses Limiting Liability to Fees Paid, Certain Claims or Insurance Recovery in Certain Jurisdictions

At present, approximately 36 states (such as, for example, California, Illinois, Indiana, Louisiana, Massachusetts, New Jersey, New York, Pennsylvania, and Texas) have upheld some version of a limitation of liability clause. The remainder of the states continue to deny enforcement, most commonly because contractually limiting liability conflicts with either a state-specific anti-indemnity statute or public policy. For example, the District Court of Nebraska in *Omaha Cold Storage Terminals, Inc. v. The Hartford Ins. Co.,* No. 8:03CV445, 2006 WL 695456 (D. Neb. Mar. 17, 2006) invalidated a limitation of liability clause which provided:

> [design professional's] total liability to the Client for any and all injuries, claims, losses, expenses, damages or claim expenses arising out this agreement, from any cause or causes, shall not exceed the total amount of $100,000, the amount of [the design professional's] fee (whichever is less) or other amount agreed upon ... Such causes include, but are not limited to, [the design professional's] negligence, errors, omissions, strict liability, breach of contract or breach of warranty

Id. at 7.

The Court's reasoning for invalidating the clause was that as a whole, contract provisions containing language which operates to insulate or limit

a design professional's liability for its own negligent acts violates the public policy of Nebraska and is invalid.

Similarly, in *City of Dillingham v. CH2M Hill Northwest, Inc.*, 873 P.2d 1271 (Alaska 1994) the Alaska Supreme Court considered the enforceability of a provision that provided:

> the Owner agrees to limit the Engineer's liability to the Owner and to all construction Contractors, Subcontractors, material suppliers, and all others associated with the Project, due to the Engineer's sole negligent acts, errors, or omissions, such that the total aggregate liability of the Engineer to all those named shall not exceed Fifty Thousand Dollars ($50,000) or the Engineer's total compensation for services rendered on the portion(s) of the Project resulting in the negligent acts, errors, or omissions, whichever is greater.

Id. at 1272.

The Court invalidated the provision on the grounds that Alaska's anti-indemnity statute prevents parties from bargaining away liability to any extent. In its decisions, the Court noted that the Alaska legislature previously considered and rejected an amendment to the anti-indemnity statute that would have explicitly exempted limitation of liability clauses. As a result, the Court concluded that the scope of the anti-indemnity statute extended beyond its plain language to include limitation of liability clauses.

Once it is determined that limitation of liability clauses are enforceable pursuant to the law in the jurisdiction governing the contract, whether to limit a client's exposure to fees earned, specific claims or available insurance proceeds, there are certain principles of which every construction lawyer should be mindful.

Guidelines for Drafting an Enforceable Limitation of Liability Clause

The states that recognize the enforceability of limitation of liability clauses are not without a significant amount of litigation surrounding those clauses. The seminal cases in many jurisdictions have assisted in providing an important framework to follow when negotiating and drafting limitation of liability provisions.

1. <u>Be Clear and Unambiguous</u>

As with any contract provision, the limitation of liability provision(s) in a construction contract must be clear and unambiguous. The Sixth Circuit Court of Appeals recently upheld a district court's decision to enforce a limitation of liability provision in a contract between a design engineering firm and a general contracting company. In *Moore & Associates, Inc. v. Jones & Carter, Inc.*, Case No. 3:05-0167, U.S. Dist. Ct. Middle Dist. Nashville, Tennessee (December 13, 2005) the court considered a contract that contained a limitation of liability provision which provided:

> In order for [owner] to obtain the benefit of a fee which includes a lesser allowance for risk funding, [owner] agrees to limit [design professional's] liability arising from [design professional's] professional acts, errors or omissions such that the total liability of [design professional] shall not exceed [design professional's] total fees for the services rendered on the project.

The District Court concluded that this contract language unambiguously limited the design engineering firm's liability to the amount of its fees and was fully enforceable.

It is critical that a limitation of liability clause is precisely drafted to cover every type of risk that may be encountered and every legal theory that a claimant could assert. Otherwise, a court may determine that the clause, although valid, is inapplicable to afford protection in a particular action. For example, design professionals are often sued simultaneously under theories of both breach of contract and negligence arising out of their performance on a particular project. A limitation of liability clause must be precisely tailored to account for both of these possibilities. In *W. William Graham, Inc. v. City of Cave City*, 289 Ark. 105, 709 S.W.2d 94 (Ark. 1986) the Court was faced with a legal challenge to a clause which provided:

> The Owner agrees to limit the Engineer's liability to the Owner and to all Construction Contractors and Subcontractors on the Project, due to the Engineer's professional negligent acts, errors or omissions, such that the total aggregate liability of the Engineer to those named shall not exceed Fifty Thousand Dollars ($50,000.00) or the Engineer's total fee for services rendered on this project, whichever is greater.

Id. at 95.

The Court found that the engineer was not entitled to the protection afforded by this provision because the engineer was found by the jury to be liable in breach of contract rather than negligence, and since the provision mentioned only negligence, "the Court could not engraft onto the contract a limitation not set forth". The Court noted that "it must also be remembered that such clauses are

not the favorite of the Court, and they will be strictly construed against the party relying on them and be limited to their exact language". *Id.* at 96.

2. Negotiate the Terms

Negotiating the terms of a limitation of liability provisions is key to its enforceability. Some states have found limitation of liability clauses unenforceable because they are adhesive and the parties did not have an opportunity to freely negotiate them. For example, in *Lucier v. Williams*, 366 N.J.Super. 485, 841 A.2d 907 (N.J.Super.A.D., 2004), the New Jersey Appellate Division considered a provision in a home inspection contract which limited an inspector's liability to lesser of $500 or half of the inspector's fee. The Court found the provision unenforceable since (in addition to contravening New Jersey public policy) "[t]here were no negotiations leading up to its preparation. The contract was presented to [home owner] on a standardized pre-preprinted form, prepared by [the inspector], on a take-it-or-leave-it basis, without any opportunity for him to negotiate or modify any of its terms". *Id.* at 493; See also, *Turnbough v. Ladner*, 754 So. 2d 467, 469 (Miss. 1999) (stating that limitation of liability clauses are not enforced unless "fairly and honestly negotiated and understandingly entered into" and are not upheld "unless the intention of the parties is expressed in clear and unmistakable language").

Importantly, the extent of the negotiations required to sustain a limitation of liability clause seems to be somewhat minimal. For example, the

Court in *Markborough California, Inc. v. Superior Court*, 227 Cal.App.3d 705, 277 Cal.Rptr. 919, considered this very issue in the context of a challenge to the enforceability of a provision in a construction contract limiting a party's liability to the developer of property for damages caused by a design professional's errors and omissions.

The Court found that to be valid under California law the limitation of liability clause must have been negotiated, which simply means that "the parties have a fair opportunity to accept, reject or modify a liability limitation provision". *Id.* at 714. The court noted that the inclusion of a cover letter accompanying the contract with the language "[i]f the contract documents are acceptable to you, we can begin work as soon as we receive a copy of the signed contract. We would, of course, have to approve any requested changes before proceeding" demonstrated that the parties negotiated the terms. *Id.* at 716.

3. Don't Be Overzealous

Be careful not to push the envelope too far when negotiating and drafting a limitation of liability clause, because if you do the entire limitation could be rendered unenforceable. For example, in *Estey v. McKenzie Engineering, Inc.,* 324 Ore. 372, 927 P.2d 86 (1996), an engineering firm was retained to perform a home inspection. The contract between the parties was a one page, four-paragraph document that contained a one sentence provision limiting the engineer's liability to the contract sum, which was $200. The Oregon Supreme

Court invalidated the clause on the grounds that it was vague and because the $200 in specified contract damages were “nominal in comparison with the damages that might foreseeably result from defendants’ negligence”.

Similarly, in *TSI Seismic Tenant Space, Inc. v. Superior Court*, 149 Cal.App.4th 159, 56 Cal.Rptr.3d 751 (Cal.App. 4 Dist.,2007) the Court found that in determining whether a limitation of liability clause was enforceable, courts must consider the amount of the limitation in comparison to the scope of the potential liability. In *TSI Seismic,* the Court found that since the evidence demonstrated that the design professional seeking to rely on a clause limiting its liability to its fee of $50,000 was responsible for approximately $3.4 million in damages it was an abuse of discretion for the lower court to enforce the limitation of liability clause “where the amount paid has no rational relationship to [the design professional’s] alleged proportionate share of liability”.

A good guiding principal is that a limitation of liability clause will be unenforceable if it establishes a limitation of liability that “is so minimal compared to [a party’s] expected compensation as to negate or drastically minimize [such party’s] concern for the consequences of a breach of its contractual obligations”. *Valhal Corp. v. Sullivan Assoc., Inc.,* 44 F.3d 195, 204 (3rd Cir. 1995). Thus, a clause limiting liability to the greater of all or a significant portion of a fee paid or a set sum higher than the fee paid, rather than a minimal sum, is much more likely to be enforced. See, e.g., *Fort Knox Self Storage, Inc. v. Western technologies, Inc.,* 142 p.3d 1 (N.M. Ct. App. 2006)(rejecting position that correct measure of whether cap is so small as to render clause unenforceable is the

difference between damages suffered and the liability cap and finding that correct measure is the difference between liability cap and expected compensation and finding that cap at greater of engineering firm's $1450 fee or $50,000 exposed it to substantial liability).

4. Confirm the Contract Provisions Are Not in Conflict

While it is always important to ensure that a contract provides a cohesive set of provisions, extra care is required when dealing with a limitation of liability clause. This is because the circumspect view that many courts have of such clauses increases the likelihood that the limitation clause will be the clause that is invalidated if it conflicts with other provisions in the agreement. In *Shorr Paper Products, Inc. v. Aurora Elevator, Inc.*, 555 N.E.2d 735 (Ill. Ct. App. 1990) the Court invalidated a limitation of liability clause that absolved Aurora, an elevator maintenance company, of any liability to the owner for a breach of its duties under its contract because this provision conflicted with the contractual requirement that Aurora perform its duties in a "good and workmanlike manner".

In finding the provision invalid the Court reasoned that "if Aurora were not liable for failing to perform its obligations sufficiently" then Aurora's duties under the agreement would become "illusory and meaningless". *Id.* at 738.

Similarly, in *JC Ryan EBCO/H & G, LLC v. Lipsky Enterprises, Inc.*, 78 A.D.3d 788, 911 N.Y.S.2d 136 (N.Y.A.D. 2 Dept. 2010), a New York Appellate court found invalid a contract clause limiting claims by a subcontractor to those

brought within a six-month limitations period because it conflicted with subcontractor's pay-when-paid clause, which conditioned contractor's obligation to make payment to subcontractor on owner's payment to contractor. The Court explained that since it was possible that the subcontractor's right to bring action against the contractor and or its right to bring an action to foreclose a mechanic's lien would not ripen until after the expiration of the six-month limitations period.

Sample Contract Provisions

1. Limitations To Certain Claims

One of the most common ways to limit liability to claims is to incorporate a contractual statute of limitations in an agreement. Courts long have recognized reasonable contractually abbreviated limitations periods for particular causes of action. As the Supreme Court discussed over sixty years ago: "[I]t is well established that, in the absence of a controlling statute to the contrary, a provision in a contract may validly limit, between the parties, the time for bringing an action on such contract to a period less than that prescribed in the general statute of limitations, provided that the shorter period itself shall be a reasonable period." *United Commercial Travelers v. Wolfe*, 331, U.S. 586, 608 (1947). A typical clause, such as the AIA B141, provides:

- As between the parties to this Agreement: as to all acts or failures to act by either party to this Agreement, any applicable statute of limitations shall commence to run and any alleged cause of action shall be deemed to have accrued in any and all event not later than the relevant Date of Substantial Completion of the Work. . . .

Another common provision limiting claims, limits potential exposure when a differing site condition is encountered. Virtually all of the standard form contracts between owners and contractors contain some type of differing site conditions clause. For example, AIA A201 (1997 ed.) provides:

- Claims for Concealed or Unknown Conditions. If conditions are encountered at the site which are (1) subsurface or otherwise concealed physical conditions which differ materially from those indicated in the Contract Documents or (2) unknown physical conditions of an unusual nature, which differ materially from those ordinarily found to exist and generally recognized as inherent in construction activities of the character provided for in the Contract Documents, then notice by the observing party shall be given to the other party promptly before conditions are disturbed and in no event later than twenty-one (21) days after first observance of the conditions. The Architect will promptly investigate such conditions and, if they differ materially and cause an increase or decrease in the Contractor's cost of, or time required for, performance of any part of the Work, will recommend an equitable adjustment in the Contract Sum or Contract Time, or both. If the Architect determines that the conditions at the site are not materially different from those indicated in the Contract Documents and that no change in the terms of the Contract is justified, the Architect shall so notify the Owner and the Contractor in writing, stating the reasons. Claims by either party in opposition to such determination must be made within twenty-one (21) days after the Architect has given notice of the decision. If the conditions encountered are materially different, the Contract Sum and Contract Time shall be equitably adjusted, but if the Owner and the Contractor cannot agree on an adjustment in the Contract Sum or the Contract Time, the adjustment shall be referred to the Architect for initial determination, subject to further proceedings pursuant to Paragraph 4.4.

While EJDC Product No. C-700, 2002 ed. provides in part:

- The Contract Price or the Contract Times, or both, will be equitably adjusted to the extent that the existence of such differing subsurface or physical condition causes an increase or decrease in Contractor's cost of, or time required for, performance of the Work; subject, however, to the

following: such condition must meet any one or more of the categories described in Paragraph 4.03A; and with respect to Work that is paid for on a Unit Price Basis, any adjustment in Contract Price will be subject to the provisions of Paragraphs 9.07 and 11.03. Contractor shall not be entitled to any adjustment in the Contract Price or Contract Times if: Contractor knew of the existence of such conditions at the time Contractor made a final commitment to Owner with respect to Contract Price or Contract Times by the submission of a Bid or becoming bound under a negotiated contract; or the existence of such condition could reasonably have been discovered or revealed as a result of any examination, investigation, exploration, test, or study of the Site and contiguous areas required by the Bidding Requirements or Contract Documents to be conducted by or for Contractor prior to Contractor's making such final commitment; or Contractor failed to give the written notice as required by Paragraph 4.03.A. If Owner and Contractor are unable to agree on entitlement to or on the amount or extent, if any, of any adjustment in the Contract Price or Contract Times, or both, a Claim may be made therefor as provided in Paragraph 10.05. However, Owner and Engineer, and any of their Related Entitled shall not be liable to Contractor for any claims, costs, losses, or damages (including but not limited to all fees and charges of engineers, architects, attorneys, and other professionals and all court or arbitration or other dispute resolution costs) sustained by Contractor on or in connection with any other project or anticipated project.

2. Limitation to Fees Paid

As discussed above, one of the most common ways to contractually limit liability is by limiting the dollar amount of potential exposure to the greater of fees paid or a sum certain. A typical provision provides:

- The liability of Consultant, and of Consultant's employees and sub-consultants, to Client, including attorneys' fees[1] awarded under this Agreement, shall not exceed an aggregate limit of $50,000 or the amount of the fee, whichever is greater regardless of the legal theory under which such liability is imposed.

[1] Including attorney's fees in the total available damages limit may dissuade challenges to the clause

3. Limitations to Insurance Recovery

Another way to limit a client's potential exposure is with a clause limiting any liability to available insurance coverage. Since many insurance policies have eroding limits, it is prudent to include the language "insurance coverage available at the time of settlement or judgment" in the event the policy limit has been eroded by other claims or legal fees.

Some examples of provisions limiting liability to insurance coverage are:

- Design Professional shall procure and maintain insurance polices with such coverages and in such amounts and for such period of time as required by and set forth in this Agreement. Owner hereby agrees that to the fullest extent permitted by law Design Professional's total liability to Owner for any and all injuries, claims losses, expenses or damages whatsoever arising out of or in any way related to the project or this Agreement from any cause or causes including but not limited to Design Professional's negligence, errors, omissions, strict liability, breach of contract or breach of warranty (hereafter "Owner's claims") shall not exceed the total sum paid on behalf of or to Design Professional by Design Professional's insurers in settlement or satisfaction of Owner's claims under the terms and conditions of Design Professional's insurance policies applicable thereto. If no such insurance coverage is provided with respect to Owner's claims, then Design Professional's total liability to Owner for any and all such uninsured Owner's claims shall not exceed $_____.

- "…shall not exceed the total sum paid on behalf of or to the Design Professional by its insurers in settlement or satisfaction of Owner's claims under the Terms and Conditions of the Design Professional's insurance policies applicable thereto ..."

Conclusion

The key to an enforceable limitation of liability clause, whether to limit liability to certain claims, to fees paid, or to insurance recovery, is to negotiate with your adversary, a provision that unambiguously accounts for all potential claims, with parameters that are reasonable, while taking careful consideration to ensure the harmony of the limitation provisions to the remainder of the contract.