

PUBLICATION

The Sky is Not the Limit: Limitation of Liability Clauses May Be the Solution to Cap Your Contractual Liability

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Who doesn't want to limit exposure from potential lawsuits and other claims that may arise? Most companies and individuals use insurance to protect themselves, but not all claims are insurable. For those claims, the use of limitation of liability clauses may be the solution.

Limitation of Liability Clause Reduces Firm's Exposure by 90%

Limitation of liability clauses in contracts just got more support in the courts. 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. *Moore & Associates, Inc. v. Jones & Carter, Inc.*, Case No. 3:05-0167, U.S. Dist. Ct. Middle Dist. Nashville, Tennessee (December 13, 2005). In that case, the design engineering firm (Jones & Carter, Inc.) contracted with a construction company (Moore & Associates, Inc.) to perform some design work in connection with the construction of a large hotel. *Id.* at 2. Two years after execution of the contract and completion of the hotel project, the owner of the hotel filed an arbitration action against Moore & Associates, Inc., alleging that the design and construction caused extensive water damage to the hotel. *Id.* at 2-3. Moore & Associates, Inc., then sued Jones & Carter, Inc., alleging that it owed a duty to defend and indemnify Moore & Associates, Inc., in the arbitration proceeding. *Id.* at 3. Jones & Carter, Inc. responded by alleging that the limitation of liability clause in the parties' contract limited the indemnification amount to the fees that were charged to the construction company for engineering services. *Id.*

The contract contained a limitation of liability provision which read, in part, as follows:

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

The District Court concluded that the contract unambiguously limited the design engineering firm's indemnity liability to the amount of their fees – \$18,109.98 versus the claim for over \$200,000 in damages. Just by having this short clause, Jones & Carter's potential exposure was reduced by 90%.

What is a Limitation of Liability Clause?

A limitation of liability clause is a provision in a contract that limits the amount of exposure a company faces in the event a lawsuit is filed or another claim is made. If found to be enforceable, a limitation of liability clause can "cap" the amount of potential damages to which a company is exposed. The limit may apply to all claims arising during the course of the contract, or it may apply only to certain types of causes of action. Limitation of liability clauses typically limit the liability to one of the following amounts: (i) the compensation and fees paid under the contract; (ii) an agreed upon amount of money; (iii) available insurance coverage; or (iv) a combination of two or more of the above.

How Enforceable Are They?

The debate with regards to limitation of liability clauses has been whether these clauses are enforceable. Some states have held that these clauses are not enforceable because they are adhesive and the parties did

not have an opportunity to freely negotiate them or they are void as a matter of public policy. See *City of Dillingham v. CH2M Hill Northwest, Inc.*, 873 P.2d 1271 (Alaska 1994) (court concluded that limitation of liability clauses were merely attempts to bargain away liability and as such were barred by the statute). In the commercial context, many states have found these clauses to be a mere shifting of the risk and enforce them as written. See *Moss v. Fortune*, 340 S.W.2d 902 (Tenn. 1960) (Limitation of liability clauses are generally valid and enforceable in Tennessee.); *Saia Food Distribs. & Club, Inc. v. SecurityLink from Ameritech, Inc.*, 902 So. 2d 46 (Ala. 2004) (The limitation of liability provision in the contract was valid and enforceable, and the maximum damages the owner could recover was \$5,800, the purchase price of the equipment.)

In general, the law permits parties to negotiate limitation of liability clauses. However, courts have refused to enforce such provisions where the court found that:

1. The provision was ambiguous or unconscionable;
2. The parties' intentions were not clearly expressed;
3. One party had unequal bargaining powers or a higher level of sophistication;
4. There was a public policy or statute prohibiting the enforcement of the provision.

Id. See also *Fox Alarm Co. v. Wadsworth*, 913 So. 2d 1070 (Ala. 2005), *J. M. Davidson, Inc. v. Webster*, 128 S.W.3d 223, 229 (Tex. 2003); and *City of Dillingham v. CH2M Hill Northwest, Inc.*, 873 P.2d 1271 (Alaska 1994) (The word "indemnify" as used in Alaska Stat. § 45.45.900 means "exempt," and thus the statute prohibits limitation of liability clauses.)

How Can Your Business Limit Potential Liability?

A limitation of liability clause is only as valuable as its ability to be enforced; therefore, drafting is key. Increasing the likelihood that a limitation of liability clause will be enforced may simply be a matter of observing the following drafting guidelines:

- Make the Clause Conspicuous: Set the clause in bold face print or underline or otherwise place the clause apart from the rest of the text on the page on which it appears so that the other party is aware of its existence.
- Make the Language Clear and Concise: Make sure that the clause is concise and unambiguous as it relates to the contract as a whole.
- Negotiate the Clause: Discuss the clause with the party that is signing the agreement and negotiate if there is a discrepancy.
- Retain Drafts of Revisions: Keep drafts of any revisions made to the limitation of liability clause so that you have proof that the clause was negotiated.

Potential claimholders against your company for breach of contract may only get to "take it to the limit" if you have your attorneys draft an enforceable limitation of liability clause in your next contract.*

** Of course, a limitation of liability clause is only enforceable against the other party to the contract. Third parties are not going to be bound by a contract they did not sign.*