LAW OFFICES

Skellenger Bender

1301 FIFTH AVENUE, SUITE 3401
SEATTLE, WASHINGTON 98101-2605
(206) 623-6501
FAX (206) 447-1973

TERENCE J. SCANLAN
tscanlan@skellengerbender.com

LIMITATION OF LIABILITY CLAUSES: CONTRACTING ISSUES

DRAFTING AN ENFORCEABLE CLAUSE THAT APPLIES TO CLAIMS THAT MAY ARISE

I. INTRODUCTION

Succeeding in convincing your client to agree to the incorporation of a limitation of liability (LOL) clause in the project contract shouldn't become a wasted effort by failing to ensure that the LOL will work when you most need it. An LOL clause should be drafted to maximize the chances that it will be enforced if a claim arises.

Frequently, considerable time and energy is spent in obtaining your client's agreement to include an LOL clause in the contract. The design professional clearly does not want this effort reduced to an exercise in futility if a court later rules that the LOL clause is unenforceable.

The good news is that more and more jurisdictions have been increasingly willing to enforce LOL clauses. Only a few jurisdictions have rejected these clauses outright. The modern trend is to enforce the contractual risk allocation the parties have bargained for.

Courts will construe all risk shifting clauses carefully. LOL clauses that are vague and poorly drafted, or that do not comply with local law may not be enforced.

The most significant lessons learned from litigating the enforceability of LOL clauses in design professional contracts concern the importance of following good contracting principles in drafting these clauses and in ensuring that they remain part of the bargain throughout the evolution of the project (even when changes in the scope of the work result in contract extensions and modifications).

At first blush, even to experienced jurists, the policy rationale behind an LOL clause appears counter-intuitive. In the face of a large claim, a court may ask, why should the design professional be allowed to limit liability to a seemingly insignificant sum? The question is not unreasonably posed: if the hired "expert" commits professional malpractice, why should his or her liability be limited to some amount potentially well below the level of damages incurred?

Just as with your own customers, courts have required convincing that an LOL clause is indeed a fair measure, rather than an unconscionable attempt by design professionals to unreasonably shed responsibility for their professional mistakes. In some instances, educating the court as to the financial realities concerning the relative risks and rewards design professionals bear relative to the owners who hire them may help to demonstrate the fundamental fairness of the LOL clause. In many instances however, there is little or no opportunity to convince the court that the LOL is fair under the circumstances. Rather, that lawyer will have to demonstrate that "fair or unfair", this is the bargain the parties negotiated and agreed to. The lawyer will then have to show that this bargained-for term was intended to apply to all work called for by the contract and to the services of the employees or subcontractors whose activities are being called into question.

This paper is intended to raise some of the practical obstacles encountered during litigation seeking to enforce LOL clauses. In the spirit of the old saying that "an ounce of prevention is worth a pound of cure," this paper will point out some of the common contracting mistakes we have seen. Most of the problems we have encountered in defending design professionals in this area frequently involve situations that could have been prevented by following prudent contracting practices. It is not uncommon to discover that a problem with enforcing an LOL clause is rooted in the original contract formation process or missteps in subsequent contract revisions and modifications.

It is assumed that the reader already has some familiarity with the basic form and operation of limitation of liability clauses. This paper will address issues that have been presented concerning LOL clauses at the time of contract formation, and following during performance of the scope of services, as well as when the scope expands or shifts.

II. CONTRACT FORMATION

A. The Enforceable Limitation of Liability Clause.

The first objective in drafting an LOL clause is to ensure that the clause will withstand scrutiny under the relevant jurisdiction's statutes and case law. While most jurisdictions have approved and enforced LOL clauses, it is nonetheless critical to stay abreast of developments concerning the enforcement of such clauses.

Knowledgeable counsel in your area should draft the LOL clause. The LOL clause (and all other provisions of your general conditions) should be reviewed by counsel periodically. Various jurisdictions have raised different concerns regarding the enforceability of LOL clauses. We identify a few of the primary or most common issues raised by the courts and suggest possible solutions.

Assuming that LOL clauses are enforceable in your state (or seem likely to be enforceable if no authority on point exists), the second objective is to ensure that the clause contains sufficient

clarity and precision as to its scope such that it meets objectives in protecting company and employee alike. This includes addressing general contracting concepts of fundamental fairness and conscionability, as well as setting an acceptable level of potential exposure relative to a liability cap amount.

1. General considerations.

a. Set out the LOL clearly and distinctly.

The LOL clause should be set out clearly and distinctly in a firm's standard terms and conditions in a readable typeface. Some firms use a bolder typeface for this clause than for others. Some firms require that this clause be initialed. We do not think these steps are necessary. However, as with all of these recommendations, these steps should be reviewed with your own counsel. The clause should be set out separately from other terms, ideally captioned as "Limitation of Liability", in print large enough to be easily read.

b. Be sure the LOL is part of the bargain.

The LOL must be a part of the contract. If the contract consists of a proposal, the general conditions and other attachments, these documents and attachments need to be clearly and specifically referenced and cross-referenced.

It should go without saying, but the design professional must ensure that along with the main body of the contract, the client is *provided* with the firm's general terms and conditions. Likewise, the design professional should ensure that a copy of the *signed* contract, including the terms and conditions, is retained in the firm's project files. Failing to follow either of these fundamental practices can be disastrous, yet we have encountered these missteps on more than one occasion.

The main body of any contract should explicitly incorporate and refer to the attached general terms and conditions, encouraging the client's careful review of all terms prior to executing the contract for the design professional's services.

If there is a factual question as to whether the LOL is part of the agreement, enforcement of the LOL will be in doubt. The court needs to be clear that this risk-shifting clause is part of the bargain the parties struck when the contract was formed.

c. The LOL should apply to all of the persons and entities doing the work.

In most jurisdictions, design professionals can be individually liable for their errors and omissions. Also, the nature of the work often dictates that services are subcontracted to other individuals or firms.

Most firms indemnify their employees from claims arising out of the scope of employment. While this indemnity protects the employee from a judgment, the firm could face exposure beyond the limitation of liability unless the LOL clause expressly applies to claims against both the firm and its individual employees.

The LOL clause should explicitly apply to claims against *both.* We encountered a case where the design firm's standard terms included an LOL clause which provided for the firm, but did not explicitly mention its professional staff. Two of the firm's engineers were the principal designers of a soil nail wall for a large luxury condominium development being built on a slope with historically unstable soils. When a portion of the soil nail wall collapsed, the plaintiff sued both the firm, as well as the two project engineers personally. Obviously the firm indemnified the two engineers, but a problem was created.

As a classic example of winning the battle and losing the war, we successfully convinced the court that the LOL clause was enforceable, only to have the court rule that the clause did not apply to the two individual engineers. This effectively defeated the liability cap and rendered the LOL clause meaningless in that litigation.

Other provisions of the general conditions and the text of the contract deliverables made it clear that the individual engineers were functioning as agents of the firm. However, the court was unwilling to construe the LOL clause this broadly. This experience underscores the importance of assuring that the LOL says exactly what you mean it to say. Ambiguities will usually be construed against the party doing the drafting.

It is axiomatic in contract law that errors or other oversights in drafting a contract will be construed against the drafter. If your firm proposed the LOL clause, a court will likely rule against your firm if faced with ambiguities in the language.

2. Scope of the LOL clause.

a. Avoid including indemnity and other risk shifting concepts in the LOL clause.

Most jurisdictions have restrictions on indemnity provisions in construction contracts. Care must be given to ensure that the clause does not invoke anti-indemnity laws, or prohibitions on exculpatory contract provisions.

An LOL clause is neither exculpatory, nor does it indemnify the design professional. It merely serves to *cap the potential financial exposure of the design professional* in the event that the design professional is liable for either negligence or breach of contract. Maintaining the distinction between indemnity/exculpatory clauses and an LOL clause is critical. At a minimum, make sure that the LOL clause and any indemnity language in the terms and conditions are in separate and distinct paragraphs. Leave no doubt that these two provisions have nothing to do with each other.

There is an excellent discussion of the policy rationale in favor of LOL clauses in *Valhal Corp. v. Sullivan Associates, Inc.*, 44 F.3d 195 (1995). The Third Circuit does a nice job of setting out the distinction between limiting liability versus either exculpatory or indemnity provisions in a case which concerned enforcement of an LOL clause on behalf of an engineer under Pennsylvania law.

b. Be sure the LOL Clause applies to all types of claims.

Design professionals can be sued under a host of legal theories. Besides the typical professional errors and omissions claims, it is increasingly common to see claims for breach of contract. The design professional contract frequently recites the applicable standard of care. Claims often allege that a deviation from the standard of care is also a breach of contract. There may be other contractual promises that give rise to the claims.

Plaintiffs' counsel constantly seek other ways to broaden liability theories against design professionals. These creative efforts are sometimes attempts to circumvent narrowly drafted LOL clauses. We have recently seen claims of breach of fiduciary duty and gross negligence as attempts to avoid an enforceable LOL.

An LOL clause should be drafted to cover any claim, no matter how pleaded, including errors of omission, breach of contract, negligence, breach of warranty or breach of fiduciary duty.

c. Limitation of Liability or Limitation of Remedies?

An LOL clause does not release or even limit the *liability* of the design professional. Rather, it limits the available *remedies* of the party bringing the claim by placing a cap on damages. A limitation on liability raises *indemnity* implications for some. Accordingly, we suggest that consideration be given to renaming the clause: **LIMITATION OF REMEDIES**.

We suggest this change in nomenclature is responsive to recent trends in the developing case law on this topic. "Limitation of remedies" is perhaps a more technically accurate designation than "limitation of liability," and may be a more persuasive term, both in marketing the clause to a client, as well as in convincing a court to enforce it.

To obtain an agreement for inclusion of an LOL clause in the contract, the design professional must educate the client as to the fundamental fairness of the clause – that it is not a shield to liability for negligence. Instead, the client must be made to understand that the LOL clause provides a measure of fairness for the design professional which accounts for the relative risks and rewards borne as between the client and the design professional.

Just as the clause must be effectively marketed to the client, so does defending the clause during litigation require that the distinction between exculpatory effect and merely limiting the range of recoverable damages be effectively communicated to the court. This, in turn, requires that at its

inception, the clause is written to maintain that distinction, as well as otherwise not running afoul of that jurisdiction's contracting rules.

3. A negotiated (and enforceable) cap amount.

Courts are sometimes loathe to enforce a limitation of liability cap amount which seems so small as to appear unfair on its face. Applying the doctrines of commercial unconscionability or the prohibition on exculpatory clauses, a court may refuse to enforce the clause if the cap is too low, given the size of the claim and the fees charged. Frequently, contract cap amounts in general conditions for smaller projects are in the range of $50,000. Cap amounts substantially below these amounts are more apt to be disfavored. Courts will frequently scrutinize the cap amount and the fees earned by the design professional to evaluate the reasonableness of the liability limit.

In the *Valhal* case mentioned above, the plaintiff argued that the LOL cap amount (in that instance, $50,000) was grossly disproportionate to the damages awarded. The court found however, that comparing those two figures was not the test for unconscionability. Instead, the court examined the relation between the fees earned (approximately $7,000) and the cap amount.

The court reasoned that the potential exposure of $50,000, approximately seven times the fees earned, was a sufficient motivator to the design professional to maintain a "concern for the consequences" of performing negligently, or of breaching the contract. The court applied a forward looking perspective from the eyes of the parties when the contract was formed, rather than looking backward from the amount of damages proved at trial ($1,000,000). When the parties agreed to a contract including the LOL clause, the engineer was potentially at risk for owing an amount significantly more than the fees earned. This reality, in the court's view, was sufficient motivation to encourage the engineer's good work. The LOL clause was therefore deemed fair, in spite of the large jury verdict.

Recently we defended a design professional under similar circumstances. In that case, the fees were approximately $23,000, the LOL cap amount $50,000, and the alleged damages approached seven figures. When we brought a summary judgement motion to enforce the cap, the trial court considered whether the fees earned relative to the cap amount provided a reasonable motivation to the geotechnical engineer to meet the standard of care. In that instance, the court agreed that the comparison of fees/cap amount (versus cap amount/damages) was the correct perspective and that the difference between fees and cap amount was great enough to be a sufficient motivation for the engineer and therefore fair.

a. Increasing the LOL cap amount.

Many design firms include language in the LOL clause allowing for an increase, or even waiver, of the cap amount in exchange for an increase in fees. This is a good idea on several levels. It is clearly more palatable to the client. From the litigation perspective, it may be powerful evidence. During a lawsuit, the client will be hard pressed to explain why the LOL cap amount

is unreasonably low when there was a mechanism in place to increase that amount in the first place, and the client chose not to avail himself of that option.

Expressing a willingness to bargain for a higher cap is strong evidence that the LOL clause was not an adhesion (a "take it or leave it") contractual term.

Finally, providing only one mechanism for changing the LOL – an increased limit in exchange for an increased fee -- serves to enhance the concept that the contract is integrated. It can only be changed by following the mechanism for change set forth in the contract.

For larger, more complex assignments, it may be unrealistic to expect that many owners will agree to a low LOL cap. However, it may be possible to negotiate a cap that is more commensurate with the complexities and scope of the work and the higher fees involved. For example, some public entities, including state departments of transportation have agreed to LOL caps at $1 million or to the limits of the required errors and omissions insurance. For these larger and high-risk projects, such an LOL may be a reasonable alternative to unlimited liability exposure.

b. Integration in the Contract and in the LOL.

Far too many cases in this industry result from confusion and ambiguity regarding what constitutes the contract. We are frequently asked to litigate cases for design professionals that turn on the questions: "what is the contract", "what is in the contract" or, " what does a particular clause in the contract mean"? An integration clause can answer the question, "what is in the contract". Such a clause can also address what it takes to change or modify the contract and what kind of evidence will be allowed to give meaning to the terms of the agreement.

A general "integration clause" is a provision that says that the general terms and conditions, and the proposal, constitute the *entire* contract between the parties, and those terms cannot be changed except by written agreement of both parties. Generally, extrinsic information, such as oral communications or even other documents (*i.e.*, correspondence), may not alter or vary the terms of the contract.

In a recent case involving a soils remediation project, at the time the contract had been formed, the client wrote to the geotechnical engineer after the contract was signed and said, "This is to confirm that you agreed to increase the liability cap from $50,000 to $1 million." The engineer did not respond to the letter. The contract contained an integration clause. The trial court concluded that the contract was "integrated" and could only be changed by writing signed by both parties. The $50,000 cap remained in force. The after-the-fact letter was not admissible to vary the plain meaning of the enforceable LOL clause.

c. General integration clause.

The benefit of an integration clause is apparent when the parties to a lawsuit produce letters, forms, telephone conference notes, and site meeting minutes to "explain" what was meant in the contract. Without the protection that an integration clause affords, you run the risk of the court rendering a radically different interpretation of the contract than the design professional intended.

The absence of an integration clause can be the difference between an exposure of $50,000 or an exposure ten times (or more) that amount. It, therefore, can mean the difference between a cost-effective, early resolution to a lawsuit, and lengthy, protracted – and expensive – litigation.

Each state has its own rules on contract interpretation, integration clauses, and the admissibility of extrinsic information to prove contract changes. Careful consideration must be given to the inclusion, as well as form, of an integration clause when contracting in a given jurisdiction.

d. Integration within the LOL clause.

In addition to the use of an integration clause in the general terms and conditions, there is a great deal of merit to adding an integration provision within the LOL clause itself. If the LOL clause allows for an increase/waiver of the cap amount, *the clause should also require that such increase/waiver be accomplished only through a written request and written agreement signed by the design professional firm.* Requiring a written agreement to increase or waive the cap amount can eliminate the claim that an oral agreement was reached to delete or modify the LOL clause.

In *Heron Ridge v. AGRA Earth & Environmental*, a real estate developer orally accepted AGRA's proposal for soils work, but objected to the LOL clause in AGRA's general terms sheet. AGRA began work without the developer's signature on the agreement, but the developer signed a subsequent agreement that also contained the identical LOL clause. When a large retaining wall failed, the developer sued AGRA for a multi-million dollar repair.

A three-judge panel of the Ninth Circuit Court of Appeals agreed with our contention that the developer had in fact accepted the LOL. The court focused on the fact that the integration language within the LOL clause only allowed for an upward adjustment of the cap amount in exchange for a fee increase. The client was not free to avoid the clause by simply voicing a verbal objection to it. The contract required that the client make a *written* request to waive the LOL clause. The client had only one choice under the contract that was offered - to modify the cap upward by paying a higher fee.

III. CONTRACT MODIFICATION AND SCOPE CREEP

Design professionals frequently encounter projects which grow in scope, either by plan or by necessity. In some instances, the project is intended to be done in phases, for which separate written agreements are executed. In other instances, an initial phase of work is all that was originally contemplated, but subsequent events result in the design professional performing additional services not anticipated in the original contract. Both of these situations require attention to the contract documents to ensure that all significant contractual terms, including the LOL clause, remain in effect.

A. Multi-phase projects.

Complex, long-term projects may involve multiple contracts or one contract document identified as a "master" agreement. If a master agreement approach is adopted, it should explicitly state that the parties intend for the "master" contract to provide controlling authority for all subsequent modifications, including an explicit statement that the general terms and conditions will control the master agreement and all subsequent modifications.

Subsequent phases of work should then be explicitly identified as an "amendment" or "modification" to the original master agreement, and should likewise explicitly refer back to the general terms and conditions contained within the master agreement as being applicable to that phase.

These suggestions may seem both simple and obvious, yet following such a practice can be critical later if litigation follows. This is essential with regard to enforcing an LOL clause, to avoid the problem of either having no LOL clause applicable to a phase of work covered under a contract amendment or modification, or in the alternative, facing "stacked" LOL clauses. Since ambiguities will be construed against the drafter, unless a clear, explicit and unambiguous contract path is created between the original agreement and subsequent modifications or amendments, the design professional may face major problems.

We defended a geotechnical firm that had done work on a site over a period of eight years. During that time, two geotechnical studies were conducted, a Phase I remediation was performed, a series of soil retaining wall systems were considered, the selected option was designed, and construction observation services were performed. When a soil nail wall failed during installation, the owner brought a claim against the geotechnical firm.

Over the course of the years the project slowly progressed, numerous contract documents were executed. However, the geotechnical engineer failed to create a consistent contract path. Some contract modifications referred back to the seminal agreement, while others did not. Some referred to the general terms and conditions, and other did not. Some of the phases of work performed by the geotechnical engineer related to the negligence claim, while others (such as the Phase I remediation) did not. The trial court ultimately found that the LOL clause was enforceable, but also found that there were essentially four separate contracts, each with separate

LOLs , and that two of these contracts applied to the negligence claims. While there was some satisfaction for the design firm that it would face no more than two "stacked" LOL cap amounts, a more palatable potential exposure all things considered, it was nonetheless an avoidable and expensive mistake.

B. Scope creep.

Another common problem is the situation that arises when the design firm gets involved in work not contemplated by the scope of services in the written contract. This may happen when the client asks for additional services, often prompted by situations encountered in the field, or when an unexpected problem pops up.

Frequently, design professionals find themselves performing these "add-on" services without the benefit of a contract amendment or modification. This may occur because the additional service seems relatively innocuous and minor in nature, or because the individuals who end up performing the extra-contractual work are field personnel not usually involved in the contract process. In any event, engaging in this sort of work without the protections of a written contract puts the design professional at risk for not having an enforceable LOL clause for those services if a claim is later made.

The failure to obtain a written agreement for the additional services makes it entirely possible that a court may decline to apply the LOL clause to a claim over negligently performed add-on services.

Although sometimes at odds with the urgent nature of many requests for add-on services, it remains imperative that *all* services be subject to a written agreement. Ideally this takes the form of an amendment or modification that explicitly refers back to the original contract, including the general terms and conditions, wherein the LOL clause can afford protection for the additional services as well.

IV. THE "RETAIL" CLIENT

The "retail" client is a can of worms unto itself, as most design professionals are likely already aware. In the context of entering into contractual relationships in general, and specifically as pertains to an LOL clause, there are special considerations of which to remain aware.

The law of contracts has long recognized distinctions between "merchants" and the average consumer. For example, in the law of sales contracts, the Uniform Commercial Code explicitly recognizes additional protections for the retail level consumer not afforded the presumably more knowledgeable and experienced, commercially sophisticated "merchant". In many jurisdictions, developing case law affords similar protections to the unwary consumer. A sophisticated developer, or other sophisticated private or governmental client with whom the design

professional typically contracts will be presumed to have both read, and understood, a contract before signing it. The same assumptions may not necessarily apply to the "retail" consumer.

An entire subset of LOL cases has developed out of the pre-purchase home inspection industry. Some courts have refused to enforce LOL clauses in these circumstances. Unfortunately, as the maxim goes, bad facts make bad law. Plaintiffs' counsel can be expected to raise those cases in other circumstances, where the typical limitation cap is something like $250, and the repair bill may run into the tens of thousands. Many courts have refused to enforce LOL cap amounts at such a low rate. Distinguishing those cases in litigation can be a problem unto itself, depending on the jurisdiction.

While many firms are not engaged in home inspections of this nature, this "bad facts/bad law" paradigm may nonetheless haunt, for example, the geotechnical engineer performing a soils analysis for a private homeowner. Some courts may look askance at an LOL clause in a contract for residential services and, at a minimum, search for any reason to find the clause unenforceable due to the "unsophisticated" nature of the "retail" consumer.

We recently represented a firm which had accepted a job involving subsurface investigation of a steep embankment adjacent to a private home, as well as designing a non-critical retaining wall for the homeowner. The homeowner was given options ranging from a robust soldier pile system, to a relatively inexpensive crib lock wall. Not surprisingly, the homeowner went with the cheapest alternative. Two years later, following 100 consecutive days of rain, culminating in 13 inches falling in the final, fateful 48 hours, the crib lock wall failed completely and spectacularly.

A written contract, including an LOL clause in the terms and conditions had been entered into with the homeowner. Following design services, the homeowner had also asked the geotechnical consultant to perform construction observation services, which were not included in the original scope of services set out in the contract. Although we were able to convince the trial court that the LOL clause was enforceable, the court declined to extend application of the clause to the construction observation phase of the work, essentially finding that the observation phase constituted a second, oral contract, to which no LOL clause applied. The consumer nature of this contract may have caused the court to apply heightened scrutiny to this contract.

IV. RECOMMENDATIONS

We offer the following general recommendations with the caveat that the law in each jurisdiction is different. Some of these recommendations may not apply to your practice. *We urge that you consult with counsel prior to attempting to introduce any of these concepts into your standard contract general terms and conditions.*

- Proposals for design professional services should be accepted in writing. Work should not commence unless a written acceptance has been obtained.

- Make certain that the LOL clause, and indeed all key portions of the terms and conditions, is set out clearly and distinctly.

- The terms and conditions should contain both a general integration clause and a specific integration clause within the body of the limitation of liability provision. The client should be allowed to increase the limitation of liability only by following a proscribed procedure in the contract. Other extraneous negotiations should give way to the formal written proposal and acceptance process.

- Consideration should be given to renaming your "limitation of liability" clause to a "limitation of remedies" clause to avoid the argument that the clauses are exculpatory in nature and run afoul of the anti-indemnity statutes.

- Indemnity provisions should be separately stated from limitation of liability provisions to avoid the confusion about these very different legal concepts.

- The contract terms and conditions should expressly apply to subsequent work assignments on the same project unless a new contract is proposed and accepted for this subsequent work. Avoid add-on assignments that are either not in writing and/or fail to refer back to the terms and conditions. Consider inclusion of a contract clause in the original agreement that explicitly makes any add-on services requested by the owner during the court of the project subject to the same terms and conditions, including the LOL.

- The LOL clause should expressly apply to claims against the firm and all employees of the firm.

- The limitation of liability (remedies) clause should expressly apply to all types of claims that could be brought.

- In the event that a design firm performs services for "retail" clients, that is, private, non-commercial individuals, extra care must be taken during the negotiation process to create a record of fair dealing. There is a far greater opportunity to later prevail on a contract enforcement issue when a court can easily conclude the "unsophisticated" client may nonetheless be presumed to have known and understood the agreement prior to execution.

- We strongly recommend that limitation of liability and all other important risk-shifting clauses be carefully drafted and frequently reviewed to ensure conformance with recent developments in the law.