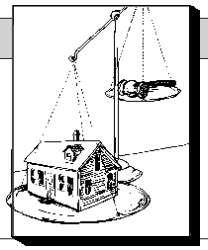
Limiting Your Liability



by Jeffrey G. Gilmore and Al B. Hill

When today's builder enters into a construction contract, his potential liability is much greater than in past years. Whether the liability is grounded in tort or in contract law, the modern-day explosion of litigation has led to greater and more frequent jury awards. This increased exposure to law suits has led to higher insurance rates for the contractor and higher construction costs in general.

In an attempt to remain competitive without taking undue risks, many businesses have adopted measures to reduce their liability. A primary tool for this purpose is the limitation-of-liability contract clause.

In the construction industry, with most materials suppliers and A/Es using limitation-of-liability clauses, the brunt of the liability falls upon the contractor, unless he too has negotiated a limitation clause. Unfortunately, contractors have been the last to adopt such clauses and their use by contractors is still not widespread.

The advantages of a limitation-of-liability clause to a contractor are obvious: the contractor can decrease his overall risk, thereby allowing him to reduce contingencies in his bid and to submit a more competitive bid. Further, the lower potential liability leads to lower insurance costs, which can also support a more competitive bid.

From the owner's viewpoint, such clauses merely shift costs from one source to another (in this case, contractor to first-party insurers). However there are reasons why an owner might choose to enter into a limitation-of-liability clause.

The two often cited advantages of a contractors' limitation-of-liability clause to an owner are (1) lower overall costs, and (2) fairness. By shifting insurance and risk costs to the owner, overall project costs may be lowered because there are some risks the owner can take on at less cost than the contractor. Certain types of business-interruption or consequential-damage insurance may cost an owner less than a contractor. The contractor can shift some of the insurance costs to the owner but lower the overall project cost. Both contractor and owner benefit.

The other oft-cited justification for limitation clauses is fairness. According to this theory, since owners typically receive the greater portion of the project's benefits, it is fair to transfer to them a greater portion of the project risk. This rationale is weak at best, however, since it presupposes that the owner is not incurring enough risk already. No amount of discussion about fairness will persuade the owner to take on added risk unless the owner feels that such a shift gives him the best deal.

Having looked at the positive aspects of limitation-of-liability clauses, we must now examine why such clauses are viewed as difficult to administer and why they have not gained greater acceptance among contractors. First and foremost is the hostility of the judicial system to limitation-of-liability clauses. Since the clause seeks to contractually alter a party's right to recovery, the courts view it as an exculpatory clause and they consistently construe the clause strictly against the party seeking to invoke it. For example, in the case of *Koppers Co., Inc. v. Island Steel Co.*, (Ind. App. 1986), the court ruled that, in order to limit the contractor's liability, the contract must specifically provide for such limitation. In that case, Koppers contracted to design and build certain facilities for Island. The design contract stated that Koppers would correct all defects in design and engineering. At trial, Koppers contended that the clause limited their liability to repair of the drawings. The court ruled, however, that Koppers was liable for repairs in the field as well as in the design room, since there was no particular, explicit, unequivocal language limiting Koppers' liability for repairs.

The *Koppers* problems can be overcome through careful, detailed drafting of the limitation clause. The problems with such a detailed clause are: (a) it is virtually impossible to draft a clause imagining every possible variant by which one may be held liable; (b) the longer the clause, the greater the legal fees; and (c) owners (especially the government) are particularly wary of accepting contracts with catch-all exculpatory clauses.

Use of such clauses may be further limited by state law. For example, Connecticut General Statutes 52-572k renders certain construction-contract provisions that seek to limit liability unenforceable.

The final obstacle to widespread use of limitation-of-liability clauses is the problem of getting the owner to agree to the clause. Even though the owner's out-of-pocket expenses may be lower with the clause, he may reject it because his total transaction cost (cost of obtaining insurance, inconvenience, etc.) outweigh the savings. And, really, the contractor can only strike a deal that is justified in the marketplace. If other contractors offer a similar price with no limitation clause, there will be no such clause in the final contract.

Though the limitation-of-liability clauses may be a very useful tool in decreasing risks and improving one's competitive position, there are very real problems with implementing such a clause.

Further, even if agreed to, the clause may be worthless if it is not drafted with enough specificity. ■

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