CONSTRUCTION - INTERNATIONAL

Limiting financial liability for contractors

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Introduction

A well-run business must manage the risks that it faces and there are many ways in which this can be done. Contractors protect themselves against the financial consequences of being sued with indemnity insurance. However, there are restrictions on the cover available. Contractors may therefore find themselves underinsured or uninsured in the event of a claim. Consequently, they cannot simply rely on their insurance; they must also actively manage liability through other means.

English common law limits the damages recoverable in the event of a breach of contract to damages which:

> "*may fairly and reasonably be considered either arising naturally, i.e. according to the usual course of things from such breach of contract itself, or such as may be supposed to have been in the contemplation of both parties at the time they made the contract, as the probable result of the breach of it.*"(1)

However, when this principle is applied to major projects in the modern era (eg, energy and other revenue-generating projects), it can lead to results which contractors are not prepared to underwrite, as the recoverable losses could be extensive.

Consequently, caps on liability are common in international projects. The first thing to consider is the basis on which the cap applies (eg, in the aggregate or on some other basis, such as a cap per claim arising from the same originating cause, which may reflect insurance cover available to the contractor) and what exclusions should apply.

Although liability cannot be excluded or restricted in relation to damages for death or personal injury, parties to a contract can agree to limit any other liability that they may incur to each other, (eg, for breach of contract or negligence). This can be done in a variety of ways. One method – now accepted by many clients – is to agree a figure (ie, a financial cap), beyond which the contractor will not be liable.

Liability caps

A cap on liability limits the amount of the contractor's liability to its client. The amount of the cap can be expressed as a fixed sum or a percentage of the fee.

Where possible, any proposed cap should be drawn to the attention of the other party to the contract. Preferably, it should be discussed and specifically agreed. If this is done, it is much more difficult for the other party to successfully challenge the cap in court. In the case of a contract of appointment, the contractor should explain to the client how the cap will operate and how it is calculated.

Where repeat work is undertaken for the same client, any cap should be negotiated and agreed for each commission. Records of the discussion – as well as any correspondence – should be retained, particularly where the other party is not legally represented. Again, it is helpful to include a note of how the cap was calculated.

Further, the level of cap employed in any particular engagement should be determined by reference to the factors that the court takes into account in determining the reasonableness of any liability limitation. If a court is required to consider the reasonableness of a cap, the options available to the court are to uphold the cap or declare it unreasonable and unenforceable.

For example, in recognition of the relative risks and benefits of a project to both the client and the contractor, the risks may be allocated such that the client agrees – to the fullest extent permitted by law – to limit the contractor's liability to the client for any claims, losses, costs, damages or claims expenses from any cause or causes (including attorneys' fees and costs and expert witness fees and costs), so that the contractor's total aggregate liability to the client shall not exceed $10,000 or the contractor's total fee for services rendered on the project, whichever is greater. This limitation would apply to any liability or cause of action, however alleged or arising.

Disclaimers

Liability for negligence can also be limited or excluded by the use of a disclaimer. This usually seeks to prevent any duty of care from arising in the first place. As with contractual exclusions, to be effective, a disclaimer must be brought to the attention of the client and must be expressed in clear and unambiguous terms. Such language is usually boldfaced or capitalised to comply with requirements for conspicuousness and validity. For example, a typical disclaimer may read as follows:

> "*Contractor makes no express or implied warranty of merchantability, fitness for a particular purpose or otherwise or all other warranties expressed or implied including the warranty of merchantability and the warranty of fitness for a particular purpose are expressly disclaimed*."

The parties may attempt to eliminate any common law or statutory remedies, instead limiting remedies to those defined in the contract, as follows:

> "*The parties' rights, liabilities, responsibilities and remedies with respect to this Agreement, whether in contract, tort, negligence, or otherwise, shall be exclusively those set forth in the Agreement*."(2)

Liability to third parties

Liability in relation to claims made by third parties cannot be excluded or restricted in the absence of a contract between them. In such case, the contractor's liability to third parties is unlimited, even where the liability to the client has been capped.

In some circumstances, third parties to the contract may also want to rely on the contractor's work or work products (eg, survey and valuation reports or schedules of condition). Where contractors are aware of this possibility when they accept the engagement, a third party may argue that the contractor has assumed a duty of care and responsibility in law to the third party on a voluntary basis, thereby enabling the third party to make a claim against the contractor. Since the third party will not be a party to the contract, it will be difficult to argue that the third party is bound by any cap on liability or other protections contained in the contractor's contractual obligations. The absence of any fee payment by the third party is unlikely to be conclusive as to whether any duty is owed.

Where a contractor enters into a collateral warranty with a third party, the contractor's liability to the third party can be limited. Standard forms of warranty limit the contractor's liability to the costs of repair and include a net contribution clause; some forms of warranty also impose a financial cap on the damages recoverable.

Limitations on recovery of incidental and consequential damages

Consequential damages are damages that can be proved to have occurred because of one party's failure to meet a contractual obligation. They go beyond the contract itself and into the actions garnished from the failure to fulfil. The type of claim giving rise to the damages can affect the rules or calculations associated with a given type of damages, including consequential damages (eg, breach of contract versus a tort claim). To be awarded consequential damages in a lawsuit, the damages must be a foreseeable result of an act. In a contractual situation, consequential damages resulting from the seller's breach include any loss arising from general or particular requirements and needs of which the seller – at the time of contracting – had reason to be aware and which could not reasonably be prevented by cover (obtaining a substitute) or otherwise.

The parties can limit the liability on recovery of consequential damages by including a clause stating that neither party shall be liable for any special, indirect, incidental or consequential damages of any nature – including, without limitation, loss of profits, loss by reason of shutdown, and loss of use or interest, among other things. Two examples of such clauses are as follows:

> "*The Parties agree that neither party shall be liable to the other for any incidental or consequential damages of whatsoever nature, however caused, whether by the negligence of the party or otherwise.*"

> "*Neither Party shall be liable for any special, indirect, incidental or consequential damages of any nature, including, without limitation, loss of profits, loss by reason of shutdown, and loss of use or interest.*"

No liability for punitive damages

The parties may wish to consider agreeing to limit their respective liabilities for punitive damages. Most common law jurisdictions allow punitive damage awards only when the injuries complained of are attended by circumstances of malicious intent or flagrant disregard for the rights of the plaintiff. For example, neither party will be liable to the other for punitive damages and/or the court shall not have jurisdiction or authority to award punitive damages.

No damages recoverable for delay

A party may also attempt to avoid liability for specific acts, occurrences or omissions. One of the most common types of damage imitation clause in the construction industry is the 'no damage for delay' clause. However, most courts are reluctant to enforce such clauses automatically, although they are generally valid. The most successful arguments to avoid application of such clauses are as follows:

- The delay was caused by the active interference (omission) of the client.
- The delay arose from a cause not contemplated by the parties when entering into the agreement.
- The delay is not within the specific wording of the clause.

A typical no damage for delay clause may read as follows:

> "*Contractor shall not be liable to Subcontractor for any delay to Subcontractor's performance of its work caused by the act or omission of the Client, or by any act beyond the Contractor's control. Or If Contractor's performance is delayed by non-negligent acts of the Client or by events beyond the Contractor's control, the Contractor shall be entitled, upon request, to a reasonable extension of time for performance, but shall not be entitled to an increase in compensation or to damages by reason of the delay.*"

Exculpatory clauses: no liability for negligence

The parties may exclude simple negligence liability in their agreement. Two examples of such exculpatory clauses are as follows:

> "*The Parties agree that neither party shall be liable to the other in negligence, or in any other legal theory (except for breach of contract and wilful, wanton or intentional conduct) for acts or omissions arising out of the subject matter of this contract.*"

> "*The parties stipulate and agree that each shall be liable to the other by reason of acts or omissions arising out of or in connection with this Agreement solely if the conduct of the party asserted to be liable is wilful, wanton or intentional. Neither party shall be liable to the other for its own negligence, breach of contract, or other claim that does not constitute a wilful, wanton, or intentional act.*"

However, exculpatory agreements are disfavoured in some legal systems, with some courts contending that they "stand at the crossroads of two competing principles: freedom of contract and responsibility for damages caused by one's own negligent acts".(3) In general, the validity of exculpatory agreements is based on:

- whether a duty to the public precludes the release of liability;
- the nature of the services performed;
- whether the contract was fairly entered into; and
- whether the language of the contract clearly and unambiguously expresses the intent of the parties.

An agreement is usually considered to be unambiguously expressed if:

- it uses simple and clear terms free from legal jargon;
- it is not inordinately long and complicated;
- the plaintiff issues a deposition statement that it understood the release; and
- the language specifically addresses a risk that describes the circumstances of the subject injury.

Damages limited to insurance

The parties to an engineering, procurement and construction contract may seek to limit their liability to the maximum amount of their respective insurance coverage. The following clause may be used to this end:

> "*Neither the Contractor, the Contractor's subcontractors, nor their agents or employees shall be jointly or individually liable to the Client in any amount in excess of the currently maintained professional liability insurance coverage carried by the Contractor.*"

Limiting damages and delays due to adverse weather conditions

Some construction contracts specifically address whether adverse weather conditions will be a basis for a contractor to claim entitlement for additional time and money and, if so, what conditions must be satisfied. Other contracts may place all risk of extreme weather conditions on the contractor or pre-emptively set and assume a certain number of days in which adverse weather conditions may affect the contractor's performance and schedule.

Comment

The types of liability limitation clause discussed above are only a few of the many clauses that might be considered; for practically every risk and problem that may arise in a construction project, there is a contract clause to eliminate or alleviate the concern.

For further information on this topic please contact Alaa Zeineddine at EMEA Legal Counsels by

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Endnotes

(1) *Hadley v Baxendale* (1854) 9 Ex 341.

(2) Section 14.7, AGC Document 410, Standard Form of Design-Build Agreement.

(3) *Heil Valley Ranch, Inc*, 784 P2d at 783.
