

Contractual Limitation of Liability Versus Indemnification of Third Parties

By Michael A. Hodgins | March 23, 2011

Lawyers are often asked questions at the contract drafting stage about contribution and indemnification clauses in general, the enforceability of damage waivers and limitations of liability, and how these clauses operate in the reality of a construction project. A February 10, 2011 Superior Court decision authored by Justice Nancy Mills provides an interesting twist on those contract drafting questions: it addresses the interplay between a contractual limitation of liability clause in an engineering firm's standard terms and conditions, and contractual or common law rights to contribution and/or indemnification for damage caused by the subcontractor. The case also addresses, but does not answer, whether an engineering subcontractor that purchases a professional liability policy with "eroding limits" has complied with contractual requirements to provide a specified level of coverage.

Kohl's Department Stores v. W/S Alfred Road Properties, LLC and S.W. Cole Engineering, Inc. arises from the construction of a Kohl's Department Store in Biddeford, Maine. S.W. Cole was hired by the general contractor to perform geotechnical engineering prior to construction of the concrete building pad. Approximately two years after construction, the owner observed cracks in the concrete slab and brought suit against the general contractor and engineering firm alleging, among other things, that the cracks were caused by differential settlement of the ground beneath the slab.

The general contractor and engineering firm brought cross-claims against each other, demanding contribution and indemnification by the other party to pay for the other party's respective share of the fault contributing to the owner's damages. The general contractor and engineering subcontractor had specifically agreed by contract to indemnify each other for all claims arising out of their own "negligent acts, errors or omissions." However, the contract was on the engineering subcontractor's standard form, which also included a limitation of liability clause which capped the engineering firm's damages for negligence or breach of contract at "either \$50,000, or [the engineer's] fee, whichever is greater." The case concerned the interplay between these two important concepts of risk allocation.

1. Limitation of Damages Defense.

The contractor and engineering firm asked the Court to determine whether the damages cap trumped the general contractor's claim for indemnification for damages incurred by the owner. The trial court ruled that the limitation of liability clause applied only to direct claims by the general contractor against the engineering firm for damages to the general contractor. The claim for indemnification for damages incurred by the owner fell outside the limitation on damages, because there was no clear language in the contract that limited the engineering firm's liability for contribution to the owner's damage claim. As the Court noted, to allow the limitation of liability clause to negate the obligation to indemnify would render the indemnification moot.

In a footnote, the Court noted that the contractor did not argue that the limitation of liability clause was unenforceable. Many jurisdictions have been receptive to that argument. Given the facts of this case, including the parties' negotiation of an increased professional liability limit in exchange for additional compensation from the general contractor, this case might have been ripe for that argument, but the question remains unanswered for now in Maine.

2. Liability Insurance Limits.

The Court also addressed an argument concerning the intent of the parties with respect to the requirement that the engineering firm procure insurance with a \$3,000,000 limit. At the contract drafting stage, the parties negotiated an increase of the standard professional liability coverage carried by the engineering firm in exchange for an additional fee on the contract. However, the professional liability coverage procured by the engineering firm had an “eroding limit” of \$3,000,000, which means the policy limits would be reduced by attorney’s fees and defense costs incurred in responding to a claim. The general contractor claimed the engineering firm failed to provide adequate insurance because the entire limit was not available for indemnification.

The parties asked the Court to determine whether the engineering firm had breached the contract to provide \$3,000,000 in liability coverage. The general contractor argued that it did not agree to an “eroding policy,” but acknowledged it did not specifically request anything more than an increase in the policy limits. The engineering firm argued that it purchased its standard errors and omissions professional liability insurance policy, which as a matter of course has eroding limits, and increased the level of coverage as requested. The trial court held that the contractual language was ambiguous as to what was meant by \$3,000,000 in coverage, therefore, a fact to be decided at trial is whether the insurance met the terms of the contract.

Here, the parties may not have given much thought to the ramifications of the eroding limits of a professional liability policy, and they certainly don’t agree on the outcome. At the contract drafting stage, policy limits are increased to address a worst case scenario, which hopefully will not be realized. However, when dealing with professional errors and omissions policies, if a party wants to “guaranty” that the full liability limits will be available to pay a claim, a clear understanding about the exact nature of the coverage may be required for the parties to adequately address their respective risks at the contract negotiation stage.

For more information about contract negotiation and risk allocation in construction contracts, please contact Mike Hodgins at mhodgins@bernsteinshur.com or 207-629-6225, or contact any member of Bernstein Shur’s Construction Law Practice Group.