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A cautionary tale of limited liability clauses

October 28 2013

It's becoming standard practice for design professionals to include limitation-of-liability clauses in contracts. Here's what developers should know.

Highlights

- Limitation of liability clauses are becoming standard provisions proposed by design professionals.
- There are good reasons for these limitations.
- Courts will likely consider a developer to be "knowledgeable" and "sophisticated."


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Within a two-year period, a developer hired an architect, and then had a hotel designed, constructed and later demolished because of structural problems.

The result to the developer was an estimated loss of $4.2 million. However, the developer's suit against the architect limited recovery to $70,000, a difference of more than $4 million between the loss and the recovery. The Seventh Circuit opinion handed down in SAMS Hotel Group, LLC v. Environs, Inc. should serve as a cautionary tale.

In 2007, SAMS Hotel Group contracted with architect Environs to design a hotel in Fort Wayne, Indiana, for a fee of $70,000. The contract for the design of the hotel contained a limitation of liability clause which read:

"The Owner (SAMS) agrees that to the fullest extent permitted by law, Environs Architects/Planners, Inc. total liability to the Owner shall not exceed the amount of the total lump sum fee due to negligence, errors, omissions, strict liability, breach of contract or breach of warranty."

When the hotel construction was nearly complete, a county building inspector found "serious structural design defects" and condemned the building. Without ever opening for business, the hotel building was demolished in 2009.

The developer's lawsuit against the architect succeeded on the question of liability; however, the architect prevailed on the enforceability of the limitation of liability clause.

In reviewing the findings at the trial court level, the Seventh Circuit Court of Appeals concluded that for these pure economic loss damages, the negotiating parties were two sophisticated business entities of equal bargaining power that were well aware of the risks involved in designing and building a hotel. The court found the limitation of liability clause was "knowingly and willingly" agreed to by the parties, and its language was clear and unambiguous. They also concludedthe contract was the result of a "freely bargained agreement of the parties."

The court systematically distinguished each argument raised by the developer in its effort to avoid the consequence of the limitation of liability clause.

The court differentiated limitation of liability clauses from indemnity clauses, which shift responsibility from one party to another, and from exculpatory clauses, which allows a party to avoid all liability. Limitation of liability clauses serve different purposes. For instance, they are not held to the same legal standing requiring the expression of the parties' intent to be "clearly and unequivocally manifest."

Despite the developer's argument that the limitation of liability clause may well have the same harsh result as an exculpatory clause or an indemnification clause, the Court of Appeals refused to give the developer any relief. The court continued emphasized the "undisputed facts show that the negotiating parties were two sophisticated business entities of equal bargaining power who were aware of the risks."

In light of the "Economic Loss Rule" as applied to construction contracts and the "general rule of freedom of contract includes the freedom to make a bad bargain," the court concluded the limitation of liability clause was enforceable and affirmed the District Court's $70,000-award against Environs.

Lessons to learn

It's becoming standard practice for design professionals to include limitation of liability clauses in contracts. In fairness to the design professionals, there are good reasons for these limitations. For a fairly limited fee, designers face great risks of enormous loss. However, developers have "reasonably fair" options available to protect themselves as well.

An obvious option is to increase the dollar cap in the limitation clause. However, the issue then becomes whether there will be assets from which to recover. A $4.2-million verdict against an entity with minimal assets would not have solved the financial disaster for SAMS.

Consider negotiating a limitation of liability cap that is equal to the limits of the professional liability coverage carried by the design professional. Coupled with this option is the need to analyze whether the coverage carried by the design professional is sufficient.

Though we rarely see losses as disproportionate as this case, we are reminded of the old adage, "hope for the best, plan for the worst." If the professional liability coverage carried by the design professional seems inadequate, the developer might consider requesting a project-specific professional liability policy be put in place. The cost can be rolled into the designer's fee or even paid directly by the developer. Extra protection is available.

And remember, the courts will likely consider a developer, as in the SAMS case, to be "knowledgeable" and "sophisticated," with contracts "freely negotiated." Taking the time to know what the contracts say, specifically in regard to the limitation of liability clause, might prove priceless.

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