

News & Types: Commercial, Competition & Trade Update

Limitation of Liability Contract Provision Enforced – Hotel Owner Loses \$4.1 Million

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It is common for a contract to include provisions that allocate risks and liabilities among the parties. These could range from a complete exclusion of any liability to a complete indemnification by one party in favor of the other. A recent 7th Circuit Court of Appeals case, applying Indiana law, highlights the importance of these provisions. (*SAMS Hotel Group, LLC v. Environs, Inc.*, 7th Circuit Court of Appeals, No. 12-2979, May 31, 2013)

SAMS Hotel Group, LLC is a hotel developer. In March, 2007, it engaged Environs to provide architectural services for construction of a six-story Homewood Suites hotel in Fort Wayne, Indiana for a fee of \$70,000. The contract included the following limitation of liability provision:

"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."

As a result, Environs limited its liability to \$70,000. The project went badly wrong costing SAMS \$4.2 million. The hotel structure was nearly complete in the spring of 2008 when serious structural defects were discovered. The county eventually condemned the structure and the hotel was demolished in 2009 without ever opening. SAMS accused Environs of breach of contract and negligence and SAMS won. Would the court really enforce such an unbalanced limitation of liability? The answer is yes.

Unfortunately for SAMS, while its claim against Environs was pending, the Indiana Supreme Court issued an important ruling in a factually similar, but unrelated, case. (*Indianapolis-Marion County Public Library v. Charlier Clark & Linard, P.C.*, 929 N.E.2d 722 (Ind. 2010)) The Indiana Supreme Court held that the "economic loss rule" applies to construction contracts under Indiana law. Under the economic loss rule, a party to a contract cannot be liable under a tort (e.g., negligence) theory for any purely economic loss caused by the party's negligent performance of the contract, absent any personal injury or damage to other property.

The district court applied the economic loss rule to the detriment of SAMS and limited SAMS' recovery to \$70,000. SAMS appealed. The 7th Circuit telegraphed how it would decide in phrasing the question as:

"Is a limitation of liability clause in a professional services contract that generally refers to liability for "negligence" and breach of contract, and that was freely bargained by two sophisticated commercial entities,

enforceable in favor of a breaching party even though the clause does not specifically refer to that party's own negligence?"

Phrasing a question in this way, how could the answer be anything but yes?

But the court meandered a little to get to this point. It noted that the contract in the case was not a consumer contract or a contract of adhesion, so consumer cases striking down such clauses were inapplicable and could not be used by SAMS for support.

But other cases provided stronger support for SAMS. Indiana courts have held that contracts that purport to indemnify or exculpate a defendant from the defendant's own negligence must be clear and unequivocal. Otherwise, they will not be enforced. In the SAMS – Environs contract provision quoted above, negligence is mentioned generally, but Environs' own negligence is not specifically referenced.

But the SAMS – Environs contract was not exculpatory or an indemnification. In other words, the contract provision did not require SAMS to indemnify Environs for Environs' own negligence, and it did not completely exculpate Environs for Environs' own negligence.

This distinction was important to the court. Said the court, "Though the Indiana courts have made specificity a requirement in indemnification and exculpatory clauses, they have not spoken so clearly regarding limitation of liability clauses in sophisticated commercial contracts."

Indemnification clauses operate as insurance, shifting the entire loss to the indemnifying party. Exculpatory clauses prevent one party from bringing a claim against the other. In contrast, limitation of liability provisions permit sophisticated commercial entities to establish a contractual ceiling to be awarded if the party limiting its damages is found liable.

The court agreed with SAMS that, if a limitation of liability clause limits a party's liability to "only nominal damages", it can be as harsh as an exculpatory clause. But the court did not view the \$70,000 limitation as "nominal." The court does not define or even explain what it would consider "nominal." The court may have viewed the amount itself as not nominal. Certainly if any of us were given, or forced to pay, \$70,000, we would not see the amount as nominal. Another possibility is that \$70,000 represented Environs entire payment (not just the profit) for the work. So the damages were actually quite costly to Environs. Apparently the court did not view "nominal" in the context of the percentage of the loss. The \$70,000 limitation was less than 2% of the total damages claimed by SAMS. But, of course, the amount of damages was unknowable when the contract was negotiated and signed.

The court cited the unfortunately timed (for SAMS) Indiana Supreme Court case applying the economic loss rule to construction contracts. "If SAMS could prevail on its argument that the limitation of liability clause in the parties' contract should be jettisoned because it does not meet the specificity standard required to limit negligence claims by contractual terms, that result would permit an end-run around Indiana's economic loss rule and SAMS's own contract with Environs."

So Environs was successful in enforcing the limitation of liability provision and SAMS was stuck with the limited recovery that was in the contract. The principal the court applied is clear - freedom of contract including the freedom to "make a bad bargain." But the exception that the court hinted at – a limitation to an amount

considered "nominal" damages – is less so. But clearly a commercial party with negotiating leverage (or with an unaware counterparty) has broad ability to limit its damages.