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Critical Path

New Guidance on the Enforceability of Limitation of Liability Provisions

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The enforceability of limitation of liability (“LOL”) provisions and the extent to which liability can be capped was recently addressed by the Arizona Supreme Court in 1800 Ocotillo v. The WLB Group, 542 Ariz. Adv. Rep. 11 (2008). The primary issues in determining the enforceability of such provisions often hinge on the application of certain public policy statutes prohibiting parties from limiting liability for negligence as well as anti-indemnity statutes restricting parties’ ability to shift liability for negligence. Such prohibitions gain support from the theory that people should be responsible for their own negligence. On the other hand, parties should also be free to contractually allocate liability as they see fit. As reflected in the decision below, the tension between these competing principles is often at issue when courts must rule upon the enforceability of LOL provisions.

In 1800 Ocotillo, a real estate developer, 1800 Ocotillo, (“Ocotillo”), entered into a contract with an engineering-architectural firm, The WLB Group, (“WLB”), to conduct a survey identifying boundary lines and rights-of-way. The contract contained an LOL provision limiting WLB’s liability to its fees. After WLB completed the survey, the canal operator claimed a right-of-way that was not reflected in the survey, which led to the City of Phoenix denying Ocotillo certain construction permits. Ocotillo subsequently brought suit against WLB for negligence and WLB defended the action by invoking the LOL provision. The trial court rejected Ocotillo’s argument that the LOL provision was against public policy. The appellate court affirmed, holding that the LOL provision was not against public policy, but remanded the case as it found the provision to constitute an assumption of risk, the defense of which must be submitted to the jury pursuant to Article 18, Section 5 of the Arizona Constitution.

The Arizona Supreme Court agreed with the general principle that commercial parties should be free to negotiate a LOL provision for claims arising out of contracts. The Court then affirmed the appellate court’s ruling that LOL provisions capping damages to reasonable amounts, i.e. fees earned, were not against public policy.

The Court specifically rejected Ocotillo’s assertion that the LOL provision violated Arizona’s anti-indemnification statute governing contracts between architects and engineers. Indemnification insulates a protected party from all liability, thereby eliminating a party’s incentive to exercise due care in the performance of a contract. In the instant case, however, the Court found that WLB retained sufficient incentive to exercise due care, because otherwise, it would “lose the very thing that induced it to enter into contract in the first place.”

The Court also vacated the appellate court’s finding that the LOL provision was an assumption of risk subject to Article 18, Section 5 of the Arizona Constitution. The Court found that an assumption of risk, traditionally, applied “only to defenses that effectively relieve the defendant of any duty,” whereas “the WLB/Ocotillo liability-limitation provision does not purport to relieve WLB of all liability nor does it have that effect.” Accordingly, because the LOL provision did not relieve WLB of all liability, it was not an assumption of risk defense requiring submission to the jury. The Court nonetheless remanded the case to the court of appeals to determine if the clause was freely negotiated between the parties or if it was contrary to Ocotillo’s reasonable expectation.

The Ocotillo decision is important for two reasons. First, it allows parties to contractually limit liability so long as the limitation does not eliminate the incentive to exercise due care. Second, it allows courts to

grant summary judgment without the need to submit the question to the jury. This preserves the primary benefit of such provisions – the efficient resolution of claims.

The law on this issue is still unsettled, as it remains unclear as to what liability cap constitutes a sufficient incentive for a party to exercise due care in the performance of a contract. Indeed, the question remains as to how limited the liability can be before it will be deemed no liability at all. The Arizona Supreme Court appeared to leave open the possibility that a contractual limit on liability could be so low as to effectively eliminate the incentive to exercise due care.

Adding yet another layer of complexity, recent decisions in other jurisdictions indicate that the enforceability of a LOL provision may also be influenced by its effect on third parties to the contract. In June 2008, the Georgia Supreme Court in Lanier at McEver, L.P. v. Planners and Engineers Collaborative, Inc., 284 Ga. 204, 663 S.E.2d 240 (2008), analyzed a LOL provision under a Georgia statute (OCGA § 13-8-2 (b)) which prohibited certain construction contracts from indemnifying a party for its negligence. The engineering firm in that case moved for partial summary judgment against a developer by seeking to enforce a contractual provision limiting exposure to its fees. Although the provision did not exculpate the engineering firm from all liability, it created a duty for the developer to indemnify the firm from any *third-party* claims in excess of its fees. Because the LOL provision absolved the protected party from liability for any potential claims brought by the public, the Court held that the provision violated the public policy principles behind the anti-indemnification statute. Cf. Baylock Grading Co., LLP v. Smith, 189 N.C. App. 508, 658 S.E.2d 680 (Ct. App. 2008) (enforcing LOL provisions where third parties were not precluded from bringing negligence actions against the negligent party).

Accordingly, under the current framework, parties are best advised to take care to create a LOL provision with a limit that has a reasonable relationship to the magnitude of the services rendered or potential liability exposure without waiving liability for third party claims. This may increase the likelihood of courts upholding the LOL provision when analyzing states' public policy and anti-indemnification statutes in the event of litigation.

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