

The North Carolina Court of Appeals Will Decide Whether Limitations of Liability Clauses Violate the Anti-indemnity Statute

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If a recent decision by a Superior Court Trial Judge in North Carolina is upheld by the North Carolina Court of Appeals (“Court of Appeals”), engineers in North Carolina may be prohibited from including “limitation of liability clauses” in their professional services contracts. These clauses are routinely used in today’s practice.

Limitation of liability clauses are typically used by engineers to limit their contractual liability on a project to an agreed upon amount with the client. Typically, the limitation on liability is capped at either the (1) amount paid by the client to the engineer under the contract, (2) amount of insurance coverage obtained by the engineer, or (3) a stipulated amount.

Pending the decision by the Court of Appeals, generally in order to be enforceable, limitation of liability clauses should be bargained for freely by the contracting parties and the parties should have equal bargaining power. The clause should not be contained in small-font boilerplate language or hidden on the back page of a proposal. The language of the clause should be clear and unambiguous. The better practice is for the engineer to raise the issue of limitation of liability with the client along with their agreement on a scope of work and contract price.

Proponents of these clauses point to the freedom of sophisticated commercial parties to contract and allocate risk, a principle long ago recognized by North Carolina law. Being able to manage the potential liability on a project allows engineers to price their services without factoring in fees to address unknown potential claims, often resulting in substantial savings to their contracting partners.

A competing public policy concern is holding parties accountable under our legal system for the consequences of their actions. After all, a contractual limitation on one’s liability has been called a “license” to breach, and North Carolina courts carefully scrutinize such provisions in other contexts. There is concern that by limiting an engineer’s liability, the engineer is being shielded from the consequences of his or her own negligence and might lose the resolve to meet the professional standard of care, resulting in increased risk to the public. Furthermore, if the engineer limits his or her liability on each project to \$50,000, some may ask what incentive is there for the engineer to procure errors & omissions insurance in an amount greater than \$50,000 or at all. Of course, the engineer or other design professional remains liable in negligence to parties other than those with whom he or she has a contractual relationship, including any members of the general public who might be injured by an engineer’s negligence and other members of a construction team who are not in contractual privity with the engineer.

Limitations of liability in North Carolina have traditionally been distinguished from complete exculpations of liability. Exculpation agreements by an engineer would likely be disallowed under North Carolina law because such an agreement would be considered contrary to a substantial public interest. The practice of engineering in North Carolina is heavily regulated by the Board of Examiners for Engineers and Surveyors in order to protect the public. North Carolina appellate courts generally have looked more favorably upon reasonable limitations of liability, but have not yet specifically addressed the enforceability of an engineering or related profession's limitation of liability clause.

On November 21, 2006, a Harnett County Superior Court Judge ("the Court") issued an order finding that a surveyor's limitation of liability provision violated the North Carolina anti-indemnity statute, making the provision void and unenforceable as a matter of law. In this case, a grading contractor and a surveyor entered into a contract containing a limitation of liability provision (referred to as a "risk allocation" in the contract) that limited the surveyor's liability to the greater of \$50,000 or the surveyor's fee.

Under N.C. Gen. Stat. § 22B-1 (the anti-indemnity statute), any agreement in a construction contract that indemnifies (or holds harmless) one of the contracting parties for damage caused by that party's negligence is "against public policy and is void and unenforceable." An indemnity agreement attempts to shift the responsibility for the payment of damages for third-party claims to someone other than the negligent party (i.e. the other contracting party). The order by the Court considers the relationship of limitation of liability clauses with the anti-indemnification statute.

In the Harnett County case, a jury found the surveyor liable to the grading contractor for \$574,714. The Court found as a matter of law that the risk allocation provision was "an attempt to provide for the indemnity of the negligence of [the surveyor] so that the [grading contractor] must sustain substantially all of the loss caused by [the surveyor's] negligence." Because the grading contractor had to finish the project with no accompanying increase in its fee to the prime contractor, the Court found that the grading contractor was "responsible for paying the prime contractor or the owner for the negligence of [the surveyor]". The Court appears to be saying that the amount of liability incurred by the grading contractor above the contracted limitation amount of \$50,000 due to the negligence of the surveyor is tantamount to the grading contractor indemnifying the surveyor for the surveyor's negligence.

The Court also relied on North Carolina case law used to void exculpatory contractual provisions where the activity "falls within the public policy exception when the activity is extensively regulated to protect the public from danger, and it would violate public policy to allow those engaged in such an activity to absolve themselves from the duty to use reasonable care." The order then cited various provisions of N.C. Gen. Stat. § 89C discussing the extensive regulation of surveyors designed to protect the public. The Court also found that the surveyor held itself out to the public as willing and capable to perform the surveying services in conformance with the professional standard of care.

The surveyor has appealed the Court's order. The Court of Appeals will have to analyze the interplay between limitation of liability clauses and the anti-indemnity statute. Courts in other states which have decided this issue are split. Courts in Alaska and Florida have held that limitation of liability clauses are prohibited by anti-indemnity statutes focusing on the similarities between the two. For instance, consider where one party limits its liability to a second party, and that second party subsequently becomes responsible to a third party for damages arising from the negligence of the first party in an amount above and beyond the limitation of liability of the first party. Functionally, this is quite similar to an indemnification agreement, and the courts have recognized it as such.

Courts in New Jersey and Pennsylvania (Federal Court of Appeals interpreting Pennsylvania law) have upheld limitation of liability clauses and have focused on the differences between limited liability clauses and anti-indemnification statutes. These courts note the limitation of liability clause does not require anyone (the second party) to be responsible for the negligence of the party limiting its liability (the first party). These courts recognize the first party remains liable for its own negligence up to the amount agreed to in the contract. They seem to view the additional step of attaching liability to the second party for third-party claims due to negligence of the first party as sufficiently differentiating limited liability and indemnification.

It is difficult to predict how the Court of Appeals will rule on this case. Several possible outcomes exist. It could agree with the Harnett County Superior Court Judge and ban all limitation of liability clauses for surveyors (and other design professionals) as void against public policy. The Court of Appeals could also find that limitations of liability are distinct and different from indemnification agreements and uphold their use. The Court of Appeals could also come down somewhere in the middle and require a reasonableness standard for limitation of liability clauses. For instance, the liability ceiling might have to bear a reasonable relationship to the amount of the entire construction project or the surveyor's fee. The Court of Appeals will likely issue its decision sometime in 2008. We will keep you posted.

Bio

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