INDEMNIFICATION, LIMITATION OF LIABILITY AND (UN)INTENDED CONSEQUENCES

State and local government procurement offices have all dealt with contractor requests for indemnification and limitation of liability. This article distinguishes between the two provisions and covers two cases that illustrate what can go wrong.

RULES GOVERNING DAMAGES AND LIABILITY

The law has rules for determining damages and what rights each party has against the other during contract performance. Suppose, for example, that a recreational district has a malfunctioning outdoor light on a tall tower. The district needs scaffolding in order to repair the light and contracts with a company for $1,800 to erect scaffolding. While the scaffolding is being erected, the light fixture falls and seriously injures a contractor employee.

The rights and liabilities arising out of the injury would be defined by "tort" law (often common law developed over time by court decisions) governing responsibility for personal injury. The law of each state defines negligence, rights of contribution among various parties when there are multiple contributing causes and the effect of governmental immunity that many governments have. When an employee is injured, statutory workers' compensation rules also weigh in.

Likewise, the contract rights and remedies are governed by the law. Had the scaffolding contractor breached its contract and not performed, the district could have claimed the extra costs to obtain a replacement contractor (a remedy known as "cover" under the UCC for transactions in goods). On the other hand, if the district breached the contract by canceling it – assuming the right to terminate early was not in the contract -- the contractor might have a claim for the profit it expected to make on the transaction and the expenses it incurred in performing.

States have their own legal frameworks for defining damages that are recoverable. Juries in lawsuits may be instructed that proof is needed by a "reasonable certainty," that damages must be foreseeable or that damages may not be remote or speculative. In the United States, most costs of litigation (including attorneys' fees) are born by the party incurring them, not the winner of the lawsuit. But the uncertainty of how rules will be applied in the various jurisdictions may be a motivating factor for the use of contract clauses that allocate liability and costs of litigation.

INDEMNIFICATION CLAUSES

Contract clauses can change who ultimately is responsible for damages. For example, an indemnification contract provision could have required the contractor to pay the ultimate liability and district's costs associated with claims or litigation arising out of performance even though the district otherwise might have been liable under the law. Many government contracts use boilerplate provisions that require the contractor to indemnify the state or local government for liability and litigation costs arising out of performance.

Some state laws limit the ability to shift responsibility for one's own negligent acts. Absent such special laws, though, as a general rule contractors and governments are considered sophisticated purchasers whose contracts will be enforced the way they are written.

LIMITATION OF LIABILITY CLAUSES

Another kind of contract term – a limitation of liability clause -- can limit liability and responsibility for damages. Such a clause can exclude the kinds of damages that can be recovered. For example, the Uniform Commercial Code permits recovery of consequential damages, those losses from requirements that the seller had reason to know at the time of contracting. In the district's case, there might have been a sporting event scheduled that was expected to generate thousands of dollars. Had the contractor breached, requiring the event to be canceled, a contract clause excluding consequential damages probably would have precluded recovery of those lost revenues.

Caps on damages arising out of performance are a common element as well in some limitation of liability clauses. Caps are limits sometimes expressed in terms of specific amounts or using multipliers of the contract price or value. The National Association of State Chief Information Officers (NASCIO) published survey results in 2010 that concluded that most states have the flexibility to negotiate limitation of liability provisions in information technology contracts. The

survey found that governments used limits of 150 to 200 percent of the contract maximum value.

SO WHAT CAN GO WRONG …

To illustrate what can go wrong when using these clauses, let's return to the rest of the scaffolding story, a real story it turns out. A December 2011 Colorado Court of Appeals decision illustrates the importance of knowing what is in the fine print. [*Thyussenkrupp Safway, Inc. v. Hyland Hills Parks and Recreation District*, No. 10CA2349 (Colo. App. Dec. 8, 2011)]

In *Thyussenkrupp*, a deputy manager signed the vendor's contract form that included an indemnification provision. That contract provision said, "[District] agrees to fully indemnify and hold harmless SAFWAY from all actions, claims, costs, damages, liabilities and expense, including reasonable attorneys' fees … which in any way arise out of [contract performance]." SAFWAY sued the district for workers' compensation amounts paid to the injured employee, citing the clause. Had the indemnity provision not been in the contract, the district might have had defenses to contribution claims by the contractor.

After a trial and appeal, the district eventually won. The appellate court did not reach the issue of the implied authority of the deputy manager – an obvious issue argued at the trial court – but instead looked at statutory authority to indemnify. In Colorado, governments cannot create liabilities without appropriations to pay for them. The district argued that there were no amounts appropriated for the workers' compensation costs. The appellate court, however, found statutory authority under public works statutes for the indemnity even without an appropriation. The contractor had not complied with certain procedural requirements of that statute, and the court held that its claims against the district were barred. Still, the district had incurred the expenses of a trial and appeal.

Limitation of liability clauses can lead to odd results also, as the Kansas Department of Labor found in 2006. [*Kansas Department of Labor v. Bearingpoint, Inc.*, No. 05-4087-JAR (U.S. District Court Kan. 2006)] In *Bearingpoint*, the state had contracted for rework of the state's unemployment insurance information technology systems. About four months into the contract, the state filed an action alleging breach of contract. The state claimed actual damages exceeding $100,000; the contractor counterclaimed for breach and damages exceeding $650,000.

The contract included a limitation of liability provision that stated, "The State agrees that [contractor's] total liability to the State or any third party for any and all damages whatsoever arising out of or in any way related to this Agreement ... shall not, in the aggregate, exceed *the fees paid to Contractor hereunder.*" [emphasis added]

The court took the parties at their word. The state had not paid the contractor anything when the lawsuit was filed. The court held that the provision was not ambiguous, and the plain language of the clause completely precluded recovery of breach damages by the state. The opinion's effect may have been softened somewhat by preserving the state's right to raise setoff defenses to the contractor's counterclaim under Kansas law. Nevertheless, the result probably was not that intended by the department.

The lessons here? Don't agree to indemnify the other party without an attorney's advice. And limitation of liability clauses tied to the amount paid under a contract can lead to bad results, especially early in performance.

UNINTENDED CONSEQUENCES

Governments want protection against financial losses caused by contractors who are in the best position to control or mitigate the risks (through insurance, for example). NASCIO's survey highlighted the flip side of the issue: companies' perceptions of unlimited liability can adversely affect competition and procurement cost. Carefully drafted, liability allocation terms can accomplish objectives of both.

Written the wrong way, though, these provisions can have unintended consequences. Yet, as a practical matter, not every purchase order or contract can or need be reviewed by an attorney. One way to exercise reasonable control is to set clear rules regarding approvals of these clauses. <

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