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Five Factors That Courts Consider When Deciding Whether to Enforce Limitation of Liability Provisions in Professional Service Agreements

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THE SCENARIO: Your professional services firm has just been sued by its (formerly) good client, alleging $500 million for your (alleged) negligence, malpractice, and breach of contract. Your firm's standard professional services agreement contains a provision limiting liability to $50,000. You breathe a sigh of relief and rush to report that the $500 million crisis has been averted, right?

THE ANSWER: Well…maybe. The good news is that most courts in most states will enforce these provisions under the theory of freedom to contract.[1] The bad news is that most courts are skeptical of these provisions and will invalidate anything they decide is "unconscionable."[2] Your chosen profession may also be a problem, as courts may be reluctant to permit professional services firms to limit their liability to clients.[3] Nor is it any exaggeration to say that the stakes are potentially staggering. In 2011, one actuarial firm was held liable for $73 million in damages for "lost" pension contributions and investment earnings, in a suit brought by its client of twenty-two years.[4] The firm did not have any limitation of liability provision in its contract, severely undercutting the argument that the parties never contemplated such exposure for its professional services.

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Limitations of liability provisions are consequently important, but are obviously only helpful to the extent they are enforceable. Fortunately, courts generally consider the same five factors when deciding whether to uphold the provision, and firms should carefully review and implement these factors into their limitation of liability provisions *before* the $500 million suit is brought.

THE FIVE FACTORS

(1) THE AMOUNT: Is the Liability Limit Unreasonably Low?

The first factor is driven by the bottom line—is the limitation amount reasonable or is it unconscionably low? Unsurprisingly, this determination varies wildly based on the jurisdiction and the judge; while some courts have enforced low limitations even in the face of high asserted damages, finding that this result is *precisely* what the parties contemplated,[5] other courts have invalidated provisions on the grounds that the amount is unconscionably low.[6] Although not always clearly articulated, the policy rationale is that low liability amounts "remove the incentive to perform with due care."[7]

The key to getting the provision enforced is convincing the court that the limitation is not unreasonably low. One effective strategy for accomplishing this is demonstrating that anything over the limitation of liability would be unreasonably *high*. Courts frequently look to the amount of the fees as a proxy for the amount of risk assumed by the contracting party, and explicitly tying the limitation of liability to the fees that the parties agreed were reasonable for the services is an effective approach.[8] This can be done by setting a limit of some multiple of the actual fees received and also including language in the contract that these fees "do not contemplate the Firm becoming involved in legal proceedings that would expose the Firm to open-ended liability." The parties can also make clear in the contract itself that the compensation for professional services reflects the allocation of risk agreed to by the parties, which courts have found to be a compelling reason for enforcing a limitation of liability tied to those fees. This first factor is a crucial one, and significant time should be spent to ensure that a court will not invalidate the parties' agreement to cap liability at an amount that is too low.

(2) THE PLACEMENT: Is the Provision Conspicuous, Concise, and Clear?

Another major factor that courts consider is whether the provision is conspicuous and understandable, or whether it is instead buried in the contract, either by physical placement or extensive legalese. The rationale behind this factor is confirming that *both* parties were aware of and in agreement with the limitation provision, and courts generally consider this question using a "reasonable person" standard.[9] If a reasonable person would not notice the provision or understand its significance when reading through the contract, there is a significant chance that a court will invalidate it.

To make sure the provision is conspicuous, firms should place the limitation of liability in a separately-numbered provision, under a bold heading entitled "**Limitation of**

Liability." The provision should be short and clear, and may be further emphasized by using different fonts, font sizes, or color. Interestingly, however, the use of all capital letters has been found to actually reduce emphasis, presumably for the same reason we tune out people yelling on talk radio stations. This second factor is also very important, because courts may strike down an otherwise-reasonable limitation amount if the provision containing it is inconspicuous or unclear.

(3) THE FORMATION: Did the Parties Negotiate the Provision?

Under the third factor, courts review the particulars of how the parties reached agreement concerning the provision. While the second factor considers whether a "reasonable person" would consider the provision conspicuous, courts may still strike down a provision where there is evidence the provision was not the product of good faith negotiation between both parties. This concern is particularly compelling where the provision is included in a contract of adhesion, or where contract is found to involve public interests or services.[10]

As a result, firms must take steps to demonstrate that the provision was willingly and knowingly entered by both parties. The primary strategy is to draw specific attention to the provision within the contract itself, which can be done in a number of ways, including: having both parties initial next to the provision, referencing the provision in correspondence sent to the client, referencing and incorporating the provision in connection with fee negotiations, and placing a statement immediately above the signature block that "this contract contains a limitation of liability provision which has been read and consented to by both parties." In fact, firms should consider doing *all* of these steps, and retain any drafts and modifications of the provision negotiated between the parties. As the primary concern under this third factor is whether both parties understood and consented to the limitation, the more opportunities that the firm has to establish these facts, the likelier it is that the provision will be enforced.

(4) THE CONTENT: What Liability is Limited?

Even if the first three factors are satisfied and the provision would be generally enforceable in most situations, a court may still decide that the provision does not apply to the particular case before it. Several courts have closely parsed language and refused to enforce a provision that did not specify it applied, for example, to *both* tort and contract actions.[11]

As a result, the provision should clearly state that the limitation of liability applies to any legal or equitable claim brought by the plaintiff, whether brought under tort, contract, malpractice, fiduciary duty, statutory, or under any other legal theory. Firms can also include language specifying that regardless of the legal theory pursued, neither party is liable for loss of profit, consequential, punitive or similar damages, and that multiple claims arising out of the same services shall be considered as a single loss for limitation purposes. Finally, many states prohibit limitations of liability for certain types of conduct, including gross negligence or willful and wanton conduct, and firms should review their ability to enter into agreements regarding this type of conduct in each jurisdiction.[12] The fourth factor considers whether an otherwise-valid provision applies under specific circumstances and to specific parties; it would obviously be cold comfort to realize that an invalidated provision would apply in 99 percent of situations.

(5) THE SCOPE: Whom Does the Provision Cover?

Finally, an otherwise air-tight provision may still be invalidated if it is not clear that the respective parties

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are covered by the limitation provision. As a result, both parties should decide *whom* will be covered by the provision: only the firm, its officers and directors, all employees, or some subset. Courts have carefully parsed these agreements and have sometimes excluded certain types of employees from the agreement—or even all *non-signatories* entirely.13 In cases where the provision is construed to only benefit the firm, plaintiffs may be able to sue the professional directly to circumvent the limitation of liability.14 Firms should address this issue by specifically defining all entities that are covered under the provision, whether or not they are actual signatories to the contract. If it appears likely that personal liability could be an issue, parties may also include an agreement not to personally name employees, directors and officers in any future lawsuit. This fifth factor confirms that all parties to the litigation were intended to be covered by the limitation provision.

CONCLUSION

So, will your firm be able to rely on its limitation of liability provision and avoid the potential $500 million judgment? While the most important, and least-controllable, factor is the proclivities of the individual judge who will control your case, there is a much better chance of enforcing a provision that is the product of careful consideration and implementation of the above five factors. Parties should confirm that existing provisions (1) set a reasonable limit, (2) are conspicuously placed in the contract, (3) are the product of documented negotiation, (4) clearly set out the liability to which they apply, and (5) cover everyone the parties intend to be covered. You may never be able to entirely escape liability in litigation, but with careful drafting, and the right judge, you should be able to limit it. ■

END NOTES:

1 The vast majority of states have upheld these provisions, albeit with varying levels of confidence. A handful of states, including Florida, Georgia, Nevada, New Jersey, and Tennessee, have cast doubts on the enforceability of limitations of liability provisions, at least in certain contexts. There is also a key distinction between provisions that entirely *eliminate* liability and those that merely *limit* liability. Unfortunately, many courts do not properly distinguish between these two types of provisions, and this article consequently focuses on the general factors courts may consider when faced with either provision. Careful review of the governing law in each jurisdiction is obviously necessary before entering into any contract.

2 *See, e.g., Lucier v. Williams,* 366 N.J. Super. 485 (App. Div. 2004) (noting "courts have not hesitated to strike limited liability clauses that are unconscionable or in violation of public policy"); *Kugler v. Romain,* 58 N.J. 522, 543 (1971) (unconscionability is an "amorphous concept obviously designed to establish a broad business ethic").

3 *See, e.g., Moransais v. Heathman,* 744 So.2d 973 (Fla. 1999) (noting it was "questionable" whether a professional "could legally or ethically limit a client's remedies by contract in the same way that a manufacturer could do with a purchaser in a purely commercial setting"); *Porubiansky v. Emory University,* 275 S.E.2d 163 (Ga. App. 1980) (a "professional person should not be permitted to retreat behind the protective shield of an exculpatory clause and insist that he or she is not then answerable for his or her own negligence"); Lucier, 366 N.J. Super. at 496 (provisions "are particularly disfavored with professional service contracts").

4 *See Milliman, Inc. v. Maryland State Retirement and Pension System,* 25 A.3d 988 (Md. App. 2011).

5 *See, e.g., 1800 Ocotillo, LLC v. WLB Group, Inc.,* 196 P.3d 222 (Ariz. 2008) (enforcing surveying firm's provision limiting liability to $14,242 in case alleging $1 million); *Schietinger v. Taucher Cronacher Prof. Engineers,* 40 A.D.3d 954 (N.Y. 2d Dept. 2007) (enforcing inspection company's provision limiting liability to its $1,705 fee); *Burns & Roe, Inc. v. Central Maine Power,* 659 F. Supp. 141 (D. Me. 1987) (enforcing provision in boiler inspector's contract limiting liability to 50% of fee earned); *City Exp., Inc. v. Express Partners,* 959 P.2d 836 (Haw. 1998) (Hawaii law "encourages" parties "to negotiate the limits of liability in a contractual situation" and holds them "to the terms of their agreement"); *SME Indus., Inc. v. Thompson et al.,* 28 P.3d 669 (Utah 2001) (noting "importance of the parties' right to negotiate the terms of a contract" and Utah's economic loss doctrine "encourages the parties to negotiate the limits of liability in a contractual situation").

6 *Pitts v. Watkins,* 905 So.2d 553 (Miss. 2005) (invalidating provision limiting home inspector's damages to $265 fee, finding it would leave the customer without an effective remedy for injury); Estey v. MacKenzie Eng'g Inc., 927 P.2d 86 (Or. 1997) (striking provision limiting liability to $200, which would "effectively immunize" defendant in action for $350,000).

END NOTES CONT.:

7 *Valhal Corp. v. Sullivan Assoc., Inc.*, 44 F.3d 195 (3d Cir. 1995) (upholding architectural firm's provision, stating "limitation of liability clauses are not disfavored under Pennsylvania law; especially when contained in contracts between informed business entities dealing at arm's length, and there has been no injury to person or property").

8 See, e.g., Moore & Assoc. v. Jones & Carter, Inc., Case No. 3:05-0167 (M.D. Tenn. Dec. 13, 2005) (unpublished) (client "was charged a lower fee and in return for that lower fee," agreed to limit "total aggregate liability" to the amount paid for services).

9 A provision should "attract the attention of a reasonable person when he looks at it." Dresser Inds., Inc. v. Page Petroleum, Inc., 853 S.W.2d 505 (Tex. 1993).

10 Hanks v. Powder Ridge Restaurant Corp., 276 Conn. 314 (2005) (voiding provision in ski resort's adhesion contract as against public policy); Rozeboom v. N.W. Bell Tel. Co., 358 N.W.2d 241 (S.D. 1984) (although provisions are not per se improper, court refused to enforce provision in contract for yellow pages advertisement because of difference in bargaining power); contrast SNET Information Services, Inc. v. O'Neal, 2011 WL 1366667 (Conn. Super. Ct. Mar. 15, 2011) (unpublished) (public policy concerns do not apply where "both parties represent sophisticated business entities").

11 *See, e.g., W. William Graham, Inc. v. City of Cave City,* 709 S.W.2d 94 (Ark. 1986) (strictly construing provision as not applying to damages for breach of contract); *DCR Inc. v. Peak Alarm Co.*, 663 P.2d 433 (Utah 1983) (parties can limit liability for both tort and contract only where the provision clearly expresses this intent).

12 *See, e.g., Chadwick v. Colt Ross Outfitters, Inc.,* 100 P.3d 465 (Colo. 2004) (parties may not limit liability for willful or wanton conduct); *Colonial Properties Realty Ltd. Partnership v. Lowder Const. Co., Inc,* 256 Ga.App. 106 (2002) (provisions cannot "relieve a party from liability for acts of gross negligence").

13 *See, e.g., In re Elizabeth Roper Carter,* 2010 WL 5396581 (Ala. Dec. 30, 2010); *Burns & Roe, Inc. v. Central Maine Power,* 659 F. Supp. 141 (D. Me. 1987).

14 *See, e.g., Witt v. La Gorce Country Club, Inc.*, 35 So.3d 1033 (Fla. App. 2010) (professional geologist was held *personally* liable for $4 million despite the fact that his firm had entered into a contract limiting liability).