# Limitations of liability in construction contracts

**Iain Murdoch** *looks at different ways in which liability can be limited in a construction contract and analyses approaches taken in some of the standard forms currently available*

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**Construction projects often run over budget and/or programme and the contract will determine which party takes responsibility. Sophisticated clients and contractors are increasingly aware of the nature of the risks associated with their projects and both standard form and bespoke contracts address allocation of risk in more and more detail.**

Various factors will affect the allocation of each risk, including political issues, the availability and economics of insurance cover, commercial bargaining power and the nature of the individual project. Often, a party is prepared to take a risk only if it knows its exposure is not open-ended, and limitation of liability is frequently accepted as going hand in hand with apportionment of risk. This briefing looks at how liability can be limited in English law construction contracts (and particularly some of the standard forms) and at what is, and is not, acceptable in the eyes of the law.

## Overall caps on liability

Commercially, a total cap on liability is the best way for a contractor to limit its total exposure. Some standard form construction contracts, particularly those used in the plant and process sector, contain express caps on the total loss which may be recovered from the contractor. For example:

> 'The total liability of the Contractor to the Employer, under or in connection with the Contract other than under Sub-Clause 4.19 [Electricity, Water and Gas], Sub-Clause 4.20 [Employer's Equipment and Free-Issue Material], Sub-Clause 17.1 [Indemnities] and Sub-Clause 17.5 [Intellectual and Industrial Property Rights], shall not exceed the sum stated in the Particular Conditions or (if a sum is not so stated) the Contract Price stated in the Contract Agreement.'
>
> (FIDIC Conditions of Contract for EPC/Turnkey Projects – extract from clause 17.6.)

FIDIC (the International Federation of Consulting Engineers) holds the view, in recommending terms for turnkey contracts, that there should be a total limitation on the contractor's liabilities, which can be agreed at any level by the parties if they so wish, but otherwise will default to the contract price. FIDIC also recommends that certain specific risks are not subject to this cap. Of those identified above, third-party indemnities and intellectual property infringement claims are commonly found outside such a cap.

The new ACE (Association of Consulting Engineers) suite of engineers' appointments also provides for a total cap on liability, as does the RIBA (Royal Institute of British Architects) standard form of architect's appointment:

> 'In any action or proceedings brought against the Architect under or in connection with the Agreement whether in contract, negligence, tort or howsoever the Architect's liability for loss or damage in respect of any one occurrence or series of occurrences arising out of one event shall be limited to… the sum… stated in the Appendix…'
>
> (RIBA SFA/99, condition 7.3.)

The maximum liability of the architect is to be an agreed sum. This is also the level of insurance which the architect agrees to carry. Perhaps given the link to insurance, RIBA has drafted an 'each and every claim' limitation, such that an architect's total liability for separate and distinct breaches or acts of negligence is subject to the agreed cap in each and every case, rather than overall.

Clauses of this nature prevent a party successfully claiming damages in full for losses suffered. Without contractual limitations, recovery would be limited only by the financial means (perhaps strengthened by insurance or third-party guarantee backing) of a defendant (subject always to the general rules as to recoverability of damages).

Simplistically, such clauses work against the client as the potential claimant. So why do clients accept them? First, if a contract is, by its very nature, high-risk, then without some way of capping its liability, a well-advised contractor or consultant may not be prepared to take on all the risks. Secondly, a contract which clearly allocates risk but which limits a consultant or contractor's liability for those risks may be more economic to take on (even with a contractor pricing for risks allocated to it), resulting in a lower cost to the client. An example of this occurs in most PFI projects, where the public sector will usually wish to pass all of the construction risk to the private sector. This gives a benefit in terms of certainty and responsibility but, in return, the risk transferred will usually be capped. This will normally be a requirement of the construction company, which may often find that the capital cost of the project actually exceeds its balance sheet.

## Consequential loss

Other forms of limitation relate to types of loss and typically have one particular aim – to exclude 'consequential losses'. It is consequential losses which may be the most unpredictable and, on certain projects, the most significant. What constitutes consequential loss will depend upon the circumstances. Often, those who refer to consequential loss are particularly keen to exclude loss of profit, but the courts have held that loss of profit may be a direct loss, at least in some cases. Without definition in the contract, the courts generally allow claims for direct losses to be all those 'arising naturally' from the breach of contract (see *Hadley v Baxendale* and *British Sugar v NEI Power Projects*).

An example of a limitation clause is the following, giving the parties the ability to cap certain types of losses at an agreed maximum:

> '... the Contractor's liability for loss of use, loss of profit or other consequential loss arising in respect of the liability of the Contractor in clause 2.5.1 [Contractor's design liability] shall be limited to the amount, if any, named in Appendix 1...'
>
> (JCT Standard Form of Building Contract with Contractor's Design, 1998 edition – extract from clause 2.5.3.)

This clause addresses loss of profit separately but does not limit the client's right to claim damages for direct losses for remedying defects in the building's design and/or construction. Likewise, if construction (rather than design) works were not completed in accordance with the contract, the losses of the client in completing those works could be recoverable, whatever their nature and value, subject to the usual common law rules and the remainder of the contract. However, where a design defect means that the client cannot use its new building, or that a lucrative opportunity to make a profit has been lost, 'loss of use' and/or 'loss of profit' claims would succeed only up to the amount of any agreed cap.

As well as simply adding certainty in the sense of being able to judge the 'worst-case' scenario under the contract for the contractor and the 'best-case' recovery for the client if things do go wrong, this drafting is also influenced by the availability of insurance at economic levels against risks of this nature.

## Delay

Other types of losses which may be limited are those arising from delays. The JCT (Joint Contracts Tribunal) clause above also provides that any liquidated and ascertained damages payable by the contractor for delay are not affected by the cap. Such liability is dealt with by reference to the date for completion with late completion (subject to extensions of time) allowing the client to claim such damages at the pre-calculated rate. The existence of an agreed contractual level of damages for late completion, at a fixed rate, can also act as a limitation of the contractor's liability. Large plant and PFI construction contracts will, typically, contain a separate overall cap on delay damages.

## Entire agreement clauses

Entire agreement clauses are included to provide for certainty in the terms of the contract. After a long negotiation, it may be in both parties' interests to agree that certain terms and conditions alone define their relationship. Parties do not want to be liable for statements or initial predictions which are not incorporated in the contract. It is imperative in contracts containing such a clause to be sure that all key terms and key documents are included or expressly referred to. The following is a typical clause:

> 'The Contract constitutes the entire agreement between the Purchaser and the Contractor with respect to the performance of the Works and supersedes all prior negotiations, representations or agreements relating thereto, whether written or oral, except to the extent that they are expressly incorporated in the Contract. No changes, alterations or modifications to the Contract shall be effective unless the same shall be in writing and signed by both parties.'
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> (*IChemE Red Book*, third edition, Article 2.)

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Whilst there are conflicting views as to whether such a clause is a limitation or exclusion clause in the strict sense, there are clearly circumstances where the effect of such a clause, if enforceable, will be to exclude any right to rely on pre-contractual representations.

It is clear that the above clause will not be allowed to exclude liability for fraud, including any fraudulent misrepresentation. Claims that a pre-contractual representation is fraudulent are relatively rare, in part because of the high burden of proof that must be demonstrated if fraud is to be

***Case references***
***Hadley v Baxendale (1854) 9 Exch 341***
***British Sugar v NEI Power Projects (1998) 87 BLR 42***

claimed in court. More common is that a claim was made negligently, or honestly but mistakenly.

Section 3 of the Misrepresentation Act 1967 imposes a reasonableness test (the same reasonableness test which applies under the Unfair Contract Terms Act 1977 (UCTA)) if a contract is to exclude liability for such a negligent and false statement. However, the Court of Appeal's view (see *EA Grimstead & Son Ltd v Francis Patrick McGarrigan*) is that entire agreement clauses are neither limitation or exclusion clauses, so the reasonableness test does not apply (see *Zanzibar v British Aerospace (Lancaster House) Ltd* for the contrary view). The Court, in *EA Grimstead & Son Ltd*, also commented that it was fair and reasonable for a contract to compel the parties to seek their remedies within a contractual framework, to the exclusion of reliance on pre-contractual representations. It is fair to say that the courts might look differently upon such an exclusion in a contract with a consumer, but in business to business transactions it seems that such a clause would not be subject to a reasonableness test and would stand.

***In addition to the statutory rules... the courts have developed a body of law to ensure that limitations and exclusions are rigorously examined.***

*Case references*
*EA Grimstead & Son Ltd v Francis Patrick McGarrigan (Unreported, 27 October 1999)*
*Zanzibar v British Aerospace (Lancaster House) Ltd [2000] 1 WLR 2333*
*Thomson v T Lohan (Plant Hire) Ltd [1987] 1 WLR 649*

## Death and personal injury caused by negligence

A recent bespoke contract contained the following provision:

> 'The Contractor shall indemnify and hold harmless the Owner from all costs, claims, damages, expenses, losses, liabilities and penalties… of every kind and nature resulting from personal injury to any person employed by the Contractor arising directly or indirectly out of or in connection with the performance of the Contract without regard to the cause thereof, including… the fault or negligence… or breach of duty… of the Owner.'

Section 2(1) UCTA states that:

> 'A person cannot by reference to any contract term or to a notice given to persons generally or to particular persons exclude or restrict his liability for death or personal injury resulting from negligence.'

The above clause may, at first glance, fall foul of s2(1). However, in commercial contracts, it may be possible to provide contractually for one party to bear the risk of personal injury or death occurring, even if caused by the other party's negligence.

Fox LJ held, deciding upon a term excluding liability for death or personal injury as between two commercial parties ('A' and 'B'), that liability to the injured individual ('X'):

> '… is the only relevant liability in the case… and that liability is still in existence and will continue until discharged by payment… Nothing is excluded in relation to the liability, and the liability is not restricted in any way whatever. The liability of [A] to [X] remains intact. The liability of [A] to [B] was sought to be excluded.'

(*Thomson v T Lohan (Plant Hire) Ltd*.)

In summary, A and B can place risks of injuries, even those caused by their own negligence, on one or the other of them as they see fit, so long as they do not seek to exclude or restrict either of their liabilities to X if they injure him.

This analysis can only be relied upon for dealings between companies. Certainly with respect to consumers, and probably with respect to professional partnerships, because the contract would then be with an individual(s), attempts to exclude liability for death or personal injury caused by negligence to such individual or individuals would be struck out of contracts by the effect of UCTA.

## Intervention by the court

In addition to the statutory rules which may affect such terms, the courts have developed a body of law to ensure that limitations and exclusions are rigorously examined. If the courts feel that there is ambiguity, they will allow this to benefit claimants rather than defendants, which will rely on such a term to limit their liability.

As well as generally interpreting exclusion clauses against those that seek to rely on them, the courts are particularly wary of attempts to exclude liability for negligence. Indeed:

> 'In case of other loss or damage [other than as set out in s2(1), above], a person cannot so exclude or restrict his liability for negligence except in so far as the term or notice satisfies the requirement of reasonableness.'
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> (Section 2(2) UCTA – this briefing does not deal with the UCTA reasonableness test, but there is a substantial body of case law on this issue, plus useful statutory guidance in schedule 2 to the UCTA.)

As a guide, if a clause is intended to exclude or limit liability for negligence, it should do so expressly.

## Insurance and liability

Whilst insurance and limitations of liability clauses are conceptually separate, when analysing limitations of liability in any contract in terms of risk to the parties involved, they are both an integral part of any such analysis. Contractual caps on liability can follow the limits of cover under insurance policies, and insurance polices can be seen as mitigating the contracting parties' risk by passing the risk and cost of certain events on to a third-party insurer. Liability is not automatically capped at an agreed indemnity insurance limit unless there is express provision to this effect.

## Conclusion

Even where the parties have chosen a particular standard form, there can often be a negotiation on key terms without an overall appraisal of risk.

By considering the placement of risk and simple but effective caps and limitations of liability where appropriate, the parties will know what they are costing when agreeing a price and the final negotiations of the contract may be simplified and the contract itself may become more cost-effective.

This review has identified some of the limitations that are frequently negotiated. There are of course many other risks that can arise. The best approach is to try to identify and address individual risks in your contract and remember that capping liability at an appropriate level can benefit all parties. IHL