Limitation Of Liability Provisions In EPC Contracts

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Law360, New York (April 18, 2017, 3:45 PM EDT) -- Under a traditional design-bid-build approach, a project owner or sponsor (referred to herein as “owner”) enters into one contract with a designer to engineer the project, another contract with a general contractor to construct the project, and possibly other contracts with suppliers to procure the project materials. Rather than entering into multiple contracts, an owner may instead choose to have a qualified firm handle all of the engineering, procurement and construction (EPC) work for a given project and to enter into a single contract (referred to as an “EPC contract”) with the firm.

There are both drawbacks and benefits to an EPC contract from the owner’s perspective. The consolidation of the engineering, procurement, and construction functions can lead to certain issues. For example, since the same firm is designing and building the project, it has an increased incentive to design a larger than necessary project. However, some owners have enough sophistication to provide the oversight necessary to prevent such issues and these owners stand to reap the benefits offered by an EPC contract. The EPC contract essentially offers one-stop shopping — because all of the work is being done by members of the same team, it may be done more efficiently and thus at a lower price and faster. Additionally, in the right hands, an EPC contract offers more cost certainty. Unlike an owner on a design-bid-build project, an owner on an EPC project will not be facing the possibility of a contractor seeking extra payment for an engineering error discovered mid-project.

As in any type of contract, there are certain provisions in an EPC contract that are often heavily negotiated and which are essential for each of the parties to clearly understand. This practice note discusses one such provision — limitation of liability. Specifically, this practice note explains why an owner would agree to limit the liability of an EPC firm (referred to herein as “contractor”) and addresses drafting considerations regarding (a) the amount of the limitation, (b) tying the amount of the limitation to insurance coverage, and (c) exclusions from the limitation.

What Is a Limitation of Liability Provision?
A contractual limitation of liability provision limits a party’s liability for damages related to the contract by way of a financial cap. A limitation of liability provision, when included in an EPC contract is typically capitalized, bolded or otherwise made conspicuous so the party against which it is to be enforced will be hard-pressed to claim insufficient notice of the clause. An example of such a clause is as follows:

To the fullest extent permitted by law, except for damages due to gross negligence or willful misconduct, contractor’s liability for damages of any type related to or arising out of the work shall not exceed the contract sum, whenever such liability is based in contract, tort, strict liability or another theory of liability.

**Why Would an Owner Agree to a Limitation of Liability Provision?**

A responsible contractor seeks to manage its risk. Sometimes, it can do this through administrative measures such as safety protocols, quality assurance and quality control. But such measures are not always adequate from the contractor’s perspective — for example, the work may be inherently dangerous, the workspace might have to be shared with other contractors or the consequences of faulty work may have extremely costly consequences, especially in light of the contractor’s available capital. In these circumstances, if a project owner does not agree to include a limitation of liability provision, it may have no qualified contractor willing to undertake its project, or none will do so without a significant amount — a cushion — added to the contract amount. Faced with either scenario, an owner often agrees to a limitation of liability provision. This is however not a one-way street. Owners also limit their liability through a combination of provisions, such as change order and notice provisions establishing the conditions for payment for extra work, and waivers of other types of payments and damages, such as delay, indirect and consequential damages (such provisions are beyond the scope of this practice note).

**Amount of the Limitation — Possible Amounts and Factors**

As noted in the sample provision above, the amount of the limitation can be related to the contract sum. The contract sum is the amount that the owner is to pay the contractor for the work to be performed under the EPC contract. The limitation amount can be equal to or a portion of that contract sum. Alternatively, it may be a multiple of the contract sum, especially where there is applicable insurance. The amount of the limitation can also be a fixed-dollar amount unrelated to the contract sum.

Five factors that drive down the amount of the limitation, and thus are relevant in negotiation of the limitation of liability provision, are as follows:

Where there is significant project risk that is outside the reasonable control of the contractor, the contractor will be less likely to put the full contract amount in play. Contractors want a reasonable assurance of gaining a certain amount of income from a project. Where this assurance cannot be provided with administrative measures, the contractor will want to do so with a limitation of liability that establishes that a certain amount of the contract sum, once earned by the contractor, cannot be recovered by the owner.
If the contractor has an established track record with the owner, which suggests that the chance of a significant incident on this project is lower. Given all of the work involved, and not just the riskier work, the likelihood is low that damages could rise to the full contract sum.

If the contractor has other jobs to keep it busy, a contractor that needs the work less will be more likely to insist on more favorable terms, including a limitation of liability with a lower cap.

If the owner does not have other contractors with which it can or wants to contract, the owner may be willing to agree to a lower dollar amount for the cap on liability.

Of course, the last two circumstances are generally relevant to the negotiation of any significant contract clause.

Issues to Be Aware of When Tying the Limitation of Liability to Insurance

Liability for damages related to the EPC contract may be limited to the amount of the contractor’s applicable insurance coverage as opposed to the contract sum or a portion thereof. If the owner and the contractor plan to tie the liability limitation to the contractor’s insurance coverage, then the following issues must be considered when drafting the contract language to avoid uncertainty in the event of damages:

When is damage “covered” by insurance? A possible scenario is that the contractor causes damage that appears to be covered according to the language of its insurance policy but its insurer objects to paying under the policy. For this reason, the parties (especially the contractor) may want to specify that the contractor’s liability is limited to the insurance proceeds actually paid out by the insurer.

What is the mechanism for determining if the insurance policy covers the damage? The parties may also want to address how insurance coverage is to be pursued. Doing so benefits both parties because the owner will have more certainty about what steps it can insist the contractor take and the contractor will have more certainty about when it has done enough. Who is responsible for what steps is negotiable, but the parties want to be sure to at least address (a) filing the insurance claim, and (b) any appropriate insurance coverage action. One of many possible ways to do this would be to provide that (a) in the event of a claim by the owner against the contractor, the contractor must in turn file claims under all potentially applicable policies and carry out a specified amount of follow up with the insurer(s); and (b) if the amount of coverage becomes the subject of litigation between the owner and the contractor, the contractor is required to join the insurer(s) so that the court’s determination of the amount of applicable coverage will be binding on the insurer(s) as well. If the parties choose to include language in the limitation of liability provision addressing these process issues, the provision should note that such language does not limit any additional insured rights that the owner may have. The insurance section of an EPC contract often requires the owner to be named as an additional insured on certain of the contractor’s policies, which status enables it to proceed directly against the insurer. Both parties may prefer to have the owner pursue the insurer directly with regard to a policy on which the owner is an additional insured.
Nothing less than the insurance bargained for in the contract. Most would agree that the contractor should bear the risk if it fails to carry the amounts and types of insurance required of it under the EPC contract. For this reason, the parties should consider adding language similar to the following, to any insurance-based limitation of liability provision:

“If the Contractor fails to maintain the contractually required insurance, in no event shall the Contractor be liable for an amount less than the coverage amount that would have been provided if the Contractor had maintained such insurance.”

Finally, it should be kept in mind that the option of tying the liability limit to insurance and to a specific monetary amount can be combined. For example, liability for damages related to the contract may be capped at the higher of available insurance proceeds or a set amount — for example, $500,000.

Common Exclusions from the Limitation of Liability

When drafting a limitation of liability provision in an EPC contract, the items detailed below are commonly excluded.

Gross Negligence and Willful Misconduct. Limiting damages for gross negligence or willful misconduct may incentivize the contractor to be less careful in supervising its workers than it otherwise would be. Based on this rationale, as noted in the sample provision above, damages due to gross negligence and willful misconduct are commonly excluded from a limitation of liability. Some jurisdictions do not have an abundance of up to date case law on what constitutes gross negligence because the jurisdiction ceased to recognize gross negligence as an independent tort standard of culpability many years ago. In these instances, the parties may want to define gross negligence as “wanton or reckless conduct,” or in other terms on which there is more up-to-date case law providing clear guidance on what constitutes the requisite misconduct.

Fraud. As a matter of public policy, fraud is usually automatically excluded from limitations of liability. Thus, expressly providing that damages due to fraud are excluded from the limitation is not usually necessary, especially where there is already an express exclusion of willful misconduct.

Third-Party Indemnification. It is also common to exclude a contractor’s obligations under the contract’s indemnification provision. An owner is often in a position to manage its own damages. For example, if the contractor’s defective work must be ripped out and replaced, the owner can employ value engineering to keep the cost of the rework under the damages cap. However, an owner has no such ability to manage the cost of third-party claims, and indemnification provisions are primarily for protecting against such claims. This is the basis on which the contractor’s indemnification obligations are excluded from the limitation of liability provision.

Liquidated damages. If the EPC contract provides for liquidated damages, the parties should address whether they count against the cap set forth in the limitation of liability provision.
Disclosure of Confidential Information. Disclosure of an owner’s trade secrets or otherwise confidential information can often threaten the owner’s business. Thus, it is not unusual for breaches of the contractor’s contractual confidentiality obligations, and any other breaches that are within the contractor’s control and carry severe consequences, to be excluded from the limitation of liability.

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