Article

Laugh Out Loud or Limitation of Liability: Why LOL Clauses Are No Laughing Matter

12.08.16

Build Houston Magazine

You might laugh in disbelief if someone told you your firm could enter into a $5 Million contract and cap its liability to the other contracting party at $50,000- obviously, the joke would be on the other contracting party if this were possible. While this example is probably on the far end of the spectrum, these types of arrangements happen more frequently than you might think in the design and construction community through what is known as a limitation of liability or LOL clause.

As the name might suggest, limitation of liability clauses are contractual clauses intended to establish the maximum amount of liability one party to a contract will ever have to the other contracting party. It's worth noting that LOLs cannot limit all liability a contracting party might be exposed to as a result of its performance of work or services under a contract because of the possibility a third party might suffer some recoverable loss that arises from the fault or negligence of the contracting party.

LOL clauses are generally enforceable in Texas. In the first case in Texas to consider the enforceability of an LOL clause contained in a construction contract, the court in CBI NA-CON, Inc. v. UOP Inc., 961 S.W. 2d 336 (Tex. App. Houston 1st Dist. 1997, review denied) held that an engineer may limit its own liability to the engineer's customer. LOL clauses have also been upheld by Texas courts in the non-construction context. See Allright v. Elledge, 515 S.W. 2d 266, LEXIS 303; 17 Tex. Sup. J. 414 (Tex. 1974).

A very basic LOL clause might simply say: "The Contractor's maximum liability to the Owner shall not exceed the sum of $_____.00." A major question mark with this and most LOL clauses is deciding what amount is appropriate to fill in the blank. Some ascribe to the theory that the maximum amount of liability established by an LOL clause should bear a reasonable relationship to the value of the contract based on notions of equity and fairness. Others believe it is more appropriate to limit the maximum liability to the amount of liability insurance required by the contract in situations where the protected party brings no assets to the negotiating table other than his insurance policy.

Additionally, if there are parent companies, subsidiaries, third party lenders, or other entities related to the contracting parties, the scope of protection afforded by the LOL clause for these types of entities should be considered by both parties.

In practice, many project owners and upstream parties that enter into design or construction contracts are reluctant to agree to LOL clauses because of their concern that they could suffer losses far in excess of the amount of the LOL. Factors such as the financial stability of the party seeking protection from an LOL, the quality of its program of insurance, and the complexity and risk associated with the project generally become part of the negotiation over whether an LOL clause makes it into a contract.

The impact of an LOL clause can be far reaching for both parties so it is important to carefully consider the benefits and risks associated with LOLs. When it comes to LOLs you don't want the joke to be on you.

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