

## FROM THE EDITOR:

THE CONSTRUCTION GROUP OF NEXSEN PRUET IS PLEASED TO PRESENT THE FIRST IN WHAT WE HOPE WILL BE A LONG LINE OF QUARTERLY CONSTRUCTION LAW ALERTS. AS AMERICA'S LARGEST BUSINESS SECTOR, CONSTRUCTION, AND THE LAWS THAT APPLY TO IT, PRESENT MANY OPPORTUNITIES FOR DISCUSSION. WHILE OUR FOCUS IS ON NEW DEVELOPMENTS, WE ARE ALSO INTERESTED IN CLARIFYING AREAS THAT TEND TO BE MISUNDERSTOOD. IF THERE IS A TOPIC YOU WOULD LIKE TO SEE ADDRESSED, PLEASE LET US KNOW. THIS IS BEING WRITTEN FOR YOU – OUR CLIENTS – AND WE WELCOME YOUR COMMENTS AND PARTICIPATION. OUR FIRST ARTICLE, BY STEVE HEDGES, OF OUR GREENSBORO, N.C. OFFICE ADDRESSES NEW DEVELOPMENTS BY ENGINEERS, AND OTHER DESIGN PROFESSIONALS, TO LIMIT THEIR LIABILITY FOR NEGLIGENCE. THIS IS A TOPIC THAT CONCERNS EVERYONE WHO PROVIDES OR USES DESIGN SERVICES. IT IS ALSO A TOPIC ON WHICH THE STATES CANNOT AGREE. OUR PURPOSE IS NOT TO PUBLISH THE DEFINITIVE WORD ON ANYTHING, BUT, RATHER, TO OPEN A DISCUSSION. FEEL FREE TO CALL ANY MEMBER OF THE PRACTICE GROUP TO TALK THIS OVER.

LAWRENCE C. MELTON

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## CONTRACTUAL LIMITS ON THE ENGINEER'S LIABILITY: It's legal in the Carolinas, but is it a good idea?

By: Steven D. Hedges

The North Carolina Court of Appeals recently held in two cases that an engineer or surveyor may contractually limit liability for defective work. *Blaylock Grading Company v. Neal Smith Engineering*, 658 S.E.2d 680 (N.C.App. 2008), *review denied*, 362 N.C. 469, 665 S.E.2d 737 (2008), *Mosteller Mansion v. Mactec Engineering and Consulting of Georgia, Inc.*, 661 S.E.2d 788 (N.C. App 2008) (unpublished) *review denied*, 362 N.C. 473, 666 S.E.2d 124 (2008).<sup>1</sup> The federal courts in South Carolina have adopted a similar rule.<sup>2</sup>

In *Blaylock*, a surveyor made a twenty inch error in setting construction benchmarks. Correcting this error cost the client \$574,714.00. In *Mosteller Mansion*, an engineer was hired to conduct a geotechnical study of a site the client was considering for the construction of apartments. The engineer's failure to discover unsuitable soil caused several million dollars of unanticipated site work. In both cases, the contract limited the engineer's liability to "an amount equal to the engineer's fee, or \$50,000, whichever is greater."

North and South Carolina are not alone in dealing with this issue. Several other states have recently considered

whether limitation of liability clauses in engineering service contracts should be enforced. The results have been inconsistent. Georgia, for example, has recently held such clauses to be unenforceable against the state's anti-indemnity statute.<sup>3</sup> Arizona, on the other hand, and also within the last year, has decided that such clauses are enforceable.<sup>4</sup> The public policy underlying these rulings warrants careful consideration.

The two North Carolina cases allow a design professional to limit liability resulting from professional negligence. In both cases, the owner, who contracted for a service meeting a standard of professional care, was left with no recovery for millions in damages. In reaching these somewhat harsh results, the court showed little concern that engineering is a profession licensed and regulated for the protection of public health and safety, and that clauses limiting liability might induce a lack of care.<sup>5</sup> Rather, the Court noted that the parties were both "sophisticated, professional parties who conducted business at arms' length," that the health and safety of the public were not at issue, and that only "economic loss" resulted.

The cases expressly rejected the argument that the

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limitation clause was barred by North Carolina's anti-indemnity statute.<sup>7</sup> The Court reasoned that N.C. G.S. § 22B-1 is limited to situations where one party attempts to shift the risk of its negligence to another party but not to situations where a party agrees directly with another to cap damages. The logic of this distinction may be lost on those who are left holding the bag for the actual damages caused by an engineer's negligence. As noted previously, Georgia has used a virtually identical statute to invalidate the same clause now accepted in North Carolina. Legislative review of this decision is warranted to determine whether the Court's have properly interpreted the statute, or whether the statute should be modified to give more protection to those who contract with licensed engineers and surveyors.

The Court of Appeals focused on the freedom of contract rather than the class of people protected by licensing laws and the N.C. anti-indemnity statute:

People should be entitled to contract on their own terms without the indulgence of paternalism by the courts in the alleviation of one side or another from the effects of a bad bargain. Also, they should be permitted to enter into contracts that actually may be unreasonable or which may lead to hardship on one side.<sup>8</sup>

It remains to be seen whether engineering firms will be able to make such limitations the norm, and not the exception, in professional practice. However, these clauses have been common for several years, particularly in contracts for geotechnical services. Owners who accepted such clauses believing them to be insignificant or unenforceable must now reconsider. All consumers of professional design services – and this may include general subcontractors and subcontractors -- must decide if they are going to accept these limitations.<sup>9</sup>

These cases are not limited to surveyors and engineers. Architects and other design professionals may be entitled, under appropriate circumstances, to limit their liability. Indeed, there appears to be no meaningful distinction upon

which to deny this protection to any of the construction contractors engaged in a building enterprise.

Approval of liability limitation clauses may prove to be more disruptive than effective. For example, an engineer may bargain to limit his liability to his client, but he remains fully liable to third parties, such as the users of the facility, who have not agreed to the limitation of liability clause. This result plainly applied in the *Georgetown Steel* case, where the engineer avoided liability to the owner but suffered a \$3.5 million judgment in favor of a third party injured by the engineer's negligence.

Because contractors may sue design professionals in the Carolinas for extra costs of construction caused by design error, one may question the benefit of including these types of clauses in owner-engineer agreements. The engineer serious about limiting his liability presumably will seek to limit liability to contractors in addition to the owner. An engineer favorably situated might succeed in having an owner include a clause limiting the engineer's liability in the general construction contract. The owner, however, could bear a heavy expense in the form of higher bids and fewer bidders by attempting to shift the risk of a design defect to prospective contractors.

An engineer's limitation of liability clause does not eliminate the harm. It just shifts the cost to others.

This new ruling could also shift the risks of design/build work. Where a design/build contractor subcontracts the design to a separate architect, the contractor is fully liable to the owner for design error but probably intends to shift that liability to the architectural firm. However, if the design subcontract includes a limitation of liability clause as approved by the Court of Appeals, the contractor would remain fully liable to the owner but would be severely limited in recovering from the architect. In such an instance the contractor would be well served to include a limitation of design liability clause in its design/build agreement with the owner. As a practical matter, the contractor's ability to bargain for such a limitation may be limited. Nevertheless, owners considering a design/build project should consider

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the risk shifting and insurance clauses very carefully.

An unintended result of *Blaylock and Mosteller Mansion* may be to encourage construction disputes. A \$50,000 limitation on design error may be enforceable, but an owner faced with costly correction of a design error will not be satisfied with inadequate recovery from the architect. Some owners in this circumstance will try and find fault with the contractor. They may seek to characterize design errors as construction defects. Such efforts will result in the contractor including the architect in the dispute under third party proceedings or separate litigation. The architect will be embroiled in litigation he thought he had avoided by bargaining with the owner for a limitation of liability. Thus, little has been achieved other than to increase the amount and cost of disputes.

An owner presented with a clause limiting design liability would be well served to evaluate the allocation of risks across the entire project to make sure he is not creating an ineffective imbalance encouraging lack of care and costly disputes. Where it is necessary for a party to incur a scope of liability it cannot afford, or which may be unfair, the owner should consider other alternatives to managing or handling the risk, rather than permit the affected party to disclaim the liability and leave it to land in some other parties' lap. For example, it may have been more effective under the facts of these new cases if the owner, rather than being left to sustain the cost of design error, had bargained with the engineer to pay more for unlimited liability or added the premium for a project professional errors and omission policy to the cost of the project.

<sup>1</sup> *Mosteller Mansion* was decided on Georgia law before the Georgia Supreme Court decided *Lanier At McEver, L.P. v. Planners and Engineers Collaborative, Inc.*, 663 S.E.2d 240 (GA. 2008) which held an engineer's limitation of liability clause unenforceable under the Georgia anti-indemnification statute. *Ga. Code Ann. § 13-8-2(b)* (2001). *Mosteller Mansion* is probably not an accurate statement of Georgia law, but it is an indication of how the North Carolina courts will treat similar issues under North Carolina law.

<sup>2</sup> *Georgetown Steel Corporation v. Union Carbide Corp.*, 806 F.Supp. 74 (D.S.C. 1992), judgment rev'd on other grounds, 7 F.3d 223 (4th Cir. 1993) (unpublished opinion), appeal after remand, 100 F.3d 950 (4th Cir. 1996) (engineer's limitation of liability clause enforced where contained in contract between parties of roughly equal bargaining power and losses limited to property). See also, *Gibbes, Inc., v. Law Engineering, Inc.*, 960 F.2d 146 (4th Cir. 1992) (applying Georgia law) (unpublished). *Gibbes* was based on

Georgia law prior to 2008 and may be invalid as a statement of Georgia law. See, note 1, *supra*. Although South Carolina state courts have not considered the issue, the rulings in *Pride v. Southern Bell Telephone and Telegraph Co.*, 138 S.E.2d 155 (S.C., 1964) (upholding a contractual limitation of liability for negligence) and *SCE&G v. Combustion Engineering, Inc.*, 322 S.E.2d 453 (S.C. 1984) (upholding contractual limitation of liability for negligent manufacture) support the federal courts' application of South Carolina law.

<sup>3</sup> *Lanier at McEver, L.P. v. Planners and Engineers Collaborative, Inc.*, 663 S.E.2d 240 (GA. 2008). Alaska and Nebraska have reached a similar result. *City of Dillingham v. CH2M Hill Northwest, Inc.*, 873 P.2d 1271 (Alaska 1994); *New Light Co., Inc. v. Wells Fargo Alarm Services, Div. of Baker Protective Services, Inc.*, 525 N.W.2d 25 (Neb. 1994).

<sup>4</sup> *1800 Ocotillo, LLC v. The WLB Group, Inc.*, CV-08-0057-PR, vacating 176 P.3d 33 (Ariz. App. 2008).

<sup>5</sup> An alternative view is that strict conformance to a "standard of care" may limit innovation. See, Henry Petroski, *To Engineer Is Human: The Role of Failure in Successful Design* (1992).

<sup>6</sup> These statements arguably leave the door open for a different result where the parties are not equal in bargaining power, health and safety are an issue and/or personal injury or third-party property damage results.

<sup>7</sup> N.C.G.S. § 22B-1 titled "Construction indemnity agreements invalid" states: Any promise or agreement in, or in connection with, a contract or agreement relative to the design planning, construction, alteration, repair or maintenance of a building, structure, highway, road appurtenance or appliance, including moving, demolition and excavation connected therewith, purporting to indemnify or hold harmless the promisee, the promisee's independent contractors, agents, employees, or indemnitees against liability for damages arising out of bodily injury to persons or damages to property proximately caused by or resulting from the negligence, in whole or in part, of the promisee, its independent contractors, agents, employees, or indemnitees, is against public policy and is void and unenforceable.

Approximately 44 states have similar laws. *Under Construction* (December 2007). The South Carolina equivalent is *S.C. Code Ann. § 32-2-10*.

<sup>8</sup> The Court's rationale is consistent with the first case to consider the issue, *Markborough California, Inc. v. Superior Court*, 227 Cal. Rptr. 919 (Cal App., 4th Dist. 1991) (the fact that the liability limitation was bargained for took it out of the California anti-indemnity statute).

<sup>9</sup> In fairness to the engineers in these cases, some contracts containing a limitation of liability clause provide for unlimited liability for an additional fee. In any event, "insurance in the amount necessary to protect a design professional on a large project is rarely affordable." *Bruner & O'Connor on Construction Law*, § 10:88 (2002).



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