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HOW TO LIMIT LIABILITY – VOLUME I
HOW DO WE BECOME LIABLE?

Nobody in their right mind gets up in the morning and exclaims, "Let's see what liability I can incur today!" For the most part liability is a thing that we seek to avoid. With every business venture comes the opportunity for profit and liability. Liability is not something that we seek it is just something that comes with the territory. It seems like everyday we hear or read about some bizarre case results. It is not uncommon to hear that a Court has awarded a sum for damages that just does not seem to comport with rational scrutiny. Sometimes this occurs as a result of less than credible reporting. On occasion the news media will report only the facts that would make the matter seem absurd and newsworthy, but if you knew all the facts the ruling would appear more reasonable. At other times, the huge awards and the logic are just plain difficult to reconcile with any type of rational thought processes. Then again, at other times, the award seems insufficient to compensate the individual for the impact to their life.

All awards are paid for by somebody; either by a business entity, the public, an individual or a combination thereof. A relatively innocent misadventure can cause millions in liability.

In this series of articles we will explore five main topics:

- How do we become liable?
- How can we use contracts to limit liability?
- How do we shield against liability?
- How do we insure against liability?
- How do we preserve your wealth?

In this Volume I, I will address the first question: "How do we become liable?"

For the purpose of this article I will assume that you either: (a) have a great idea and are considering starting a new business; or (b) own a successful business. You are looking forward to reaping the rewards of your hard work and or genius. Last on your list of desires is to be sued and absolutely last on that list is to lose all that you have earned! Before we can truly understand how to limit our liability we must understand how we can become liable in the first place. This comes under the concept that you cannot limit what you do not understand.

Although to be liable can mean a lot of things, for the purpose of this newsletter we will define "**liability**" as accountability and responsibility to another individual, which is enforceable by civil remedies in the Courts. As a general rule, when you are criminally liable you may also have some civil liability. As you will see below, the theories of liability are many, creative and not necessarily fixed. There is a lot of liability going around and if you conduct business there are many ways in which you may incur unwanted liability. In the business environment you are primarily concerned with three types of liability: (a) criminal; (b) civil and (c) contractual. The focus of this series of articles is civil and contractual liability.

Why Should I be Concerned?

Sooner or later you are liable to be liable for something! Liability can come about voluntarily, by entering into an agreement where you agree to be liable or involuntarily from acts, omissions to act when you have a duty to act and through fictions in the law − i.e., "the just because theory" of liability. I think that it is fair to say that I truly do not know of anyone that has not been liable for something due to an act or omission to act or just because.

Recently, I made the statement to a small group and I was immediately challenged by a witty friend, "Brother there was one that was perfect, and did no harm!" I thought for a moment, and replied; "I think you are referring to a well known individual who happened to reside and frequent the area commonly known as Israel on or about 2000+ years ago. As I seem to remember, although he was certainly innocent enough and many perceived him to be totally without flaw he had his detractors. Although pure in all, he received one of the stiffest of penalties for his alleged acts. Hanging on a piece of wood with spikes through his body parts until dead is extremely prejudicial. It is also widely believed that he

recovered quickly without the use of steroids. Most of us would have found this sort of liability a life altering event. It was also well known that the minute the word was spread about his surviving the crucifixion his detractors sought to serve civil process on him. The allegations of civil and criminal liability were many. The Claimants were most anxious to commence this suit, this is a slam dunk, this guy thinks he is God; the veracity of his entire testimony will be suspect! Secondly, they figured worst case scenario, he proves he is God and we still win since nobody is above the law and we can proceed against his employer under the theory of "respondeat superior". Hearsay has it that his employer has some very deep pockets and makes Bill Gates look like a pauper! One of the more troublesome of the allegations rested on an incident that occurred at the local Temple. According to the complaint he committed several tortious acts including but not limited to numerous assaults, batteries, damage to personal property, intentional trespass and intentional infliction of emotional distress. He allegedly committed all of these acts by turning over tables and using a whip on some merchants. After much frustration the local Marshall reluctantly admitted that despite his best efforts he was unable to serve process on him, something about the offender "disappearing while eating on one occasion and on another being taken up in a cloud when approached." Although disheartened, this did not dismay the Pharisees and the Sadducees and once his final location was verified they diligently pursued extradition but such requests were denied. Thank God my friend has a good sense of humor and his infectious laughter saved the moment despite my mediocre attempt at humor.

Theories of Liability

Liability can arise under other numerous legal theories including but not limited to:

(a) **alternative**, imposed on multiple civil wrongdoers when there are simultaneous tortious acts (i.e., civil wrongs) and uncertainty as to which act was the proximate cause of an injury (joint liability imposed on multiple tortfeasors i.e., those who commit civil wrongs) when there are simultaneous tortious acts and uncertainty as to which act was the proximate cause of an injury (for example tire explodes, is it the tire manufacturer, car manufacturer, wheel manufacturer etc.);

(b) **contingent**, an amount or sum or duty that will be owed if a certain event were to occur (the classic example is co-signing for a loan and the party primarily responsible defaults);

(c) **contractual**, is responsibility assumed via a legally binding agreement. Sometimes this assumption is voluntarily assumed at other times it is of an adhesive nature. This liability can be contingent, variable or fixed;

(d) **corporate**, when a validly existing corporation exists and the judgment or award is against the corporate entity, such liability is enforced by sanctions imposed against the corporation itself and not against shareholders;

(e) **criminal**, imposed by a person's violation of a criminal law. Most criminal liability is thought of in the way of misdemeanors and felonies; neither is good and can result in the loss of your freedom. Most of us will not face prosecution for a misdemeanor or a felony during our lifetimes. A felony is a crime which is punishable with death or by imprisonment in the state prison. Every other crime or public offense is a misdemeanor except those offenses that are classified as infractions (California Penal Code § 17a). An infraction is not punishable by imprisonment. A person charged with an infraction shall not be entitled to a trial by jury. A person charged with an infraction shall not be entitled to have the public defender or other counsel appointed at public expense to represent him or her unless he or she is arrested and not released on his or her written promise to appear, his or her own recognizance, or a deposit of bail (California Penal Code § 19.6). Unfortunately, most of us will face liability for this quasi-criminal liability known as an infraction. Although some violations of the vehicle code are misdemeanors and felonies most are infractions and although costly and darn inconvenient this liability can be disposed of by paying three fines. One official one to the State and the other unofficial ones to your auto insurance carrier and traffic school operator;

(f) **employer**, "respondeat superior" imposed on an employer for on-the-job injuries to employees and others. This sort of liability is imposed for acts or omissions to act committed during the course and scope of your employees fulfilling their duties;

(g) **fixed,** is the type of responsibility that is generally set forth in a contract that will mature at a fixed time specified in the contract;

(h) **joint**, that is shared by and between two or more persons;

(i) **joint and several**, imposed on all individuals civilly responsible for the damages and allows enforcement of the entire judgment against any one individually or all of these individuals;

(j) **personal**, imposed on an individual rather than a legal entity;

(k) **premises or environmental**, imposed because you are the owner or operator of a premises;

(l) **products**, imposed on a manufacturer or seller (all levels) for the placing of a defective product into commerce;

(m) **strict or absolute**, is imposed as a legal fiction without a finding of fault;

(n) **vicarious**, that is imposed for acts of another because of a legal fiction.

The first and probably the most common liabilities incurred are pursuant to a contract. The second most common liabilities are incurred because you committed a "**tort**" that is a wrongful act other than a breach of contract that injures another and for which the law (State or Federal) imposes civil liability.

The only good thing about civil and contractual liability is for the most part it is the type of liability that can be generally discharged by the payment of money to the person harmed. At other times, it can be satisfied by simply agreeing to refrain from doing a certain act.

Contractual Liability

Anyone who is of sound mind and of proper age may make an informed decision and determine to be responsible pursuant to a contract. Probably the most common contractual liability

and the first liability that you voluntarily assumed was for the purchase of your first car. In this circumstance, you agreed to make payments pursuant to a contract. The most frequent type of voluntarily assumed liability is probably credit card liability.

In each of the above circumstances, you agree to become contractually liable for the payment of a specified sum of money for the obtaining of a desired or necessary service or good.

The next most common illustration of assumed contractual liability is when you agree to be responsible for the acts or omissions to act of another. This sort of liability commonly occurs when a parent agrees to co-sign or guaranty a loan given to his/her child. This is also known as contingent liability since this liability is only triggered when and if the child defaults or breaches the loan.

In the business world liability by and between parties is always an issue. It is an extremely rare event if you see a contract that does not allocate liability by and between the parties. As a general rule, the bigger most powerful party to the transaction will seek to be liable for little and will seek to be indemnified from most liability by the smaller party to the transaction. Obviously, the larger more powerful parties are not always successful in this quest but it is not for the lack of trying.

Some industries operate and rely heavily on custom and usage and do not as a general rule attempt to spell out all of their customs in long and detailed contracts. This tends to be true in the older more tried and tested industries. Commerce occurs despite the non-existence of agreements spelling out every detail, however when issues arise the parties are often in dispute on what is the custom and usage in the industry. You ask why is this the case? The answer is simple; they started out trusting each other, paper was not the goal business was, they didn't make their money writing contracts and most didn't have a team of lawyers to write everything down. Their reputation was their word and their word was their bond. A handshake sealed the deal and they stood by their word.

There are two types of custom and usage to consider, first the custom and usage by and between the parties (how did they historically acted with each other) and in the industry as a whole. Even in these tried and true industries the pace of business has quickened and liability avoidance is becoming more of a concern. The basic problem with not spelling it out in a contract is that when and if a problem occurs the parties often will litigate when liability transfers from one party to another. The old, "I thought you had that covered!" Secondly, if custom and usage are so well grounded then why are there people making a living providing expert testimony as to custom and usage? My simple solution is if it is industry standard known then let's spell it out. In this fashion we can all agree what the industry standard is and not be dictated to by a so called expert. When I have been successful in convincing my client to take the time and effort to spell out the "unequivocally clear and well settled custom and usage", it has never ceases to amaze me just how divergent each parties view of just what are the industry standards!

The other caveat I have in the area of contracts is the old; "Just sign it, I don't even know what it means, it is a standard form." Beware of the party asking you to sign a standard form. Your first question should be who created this standard form? Many associations have taken the time to create standard forms of agreements to be used in their field of endeavor. A little bit of common sense goes a long way here. If the form was developed by an association who represents a particular profession, who do you think the form will favor? OK, so what, a contract is a contract, why should I be concerned if this form was developed by a certain profession? First, with a few exceptions, most of us do not enjoy reading contracts. In particular we do not enjoy the reading the boilerplate. When you agree to use an industry standard form more than likely you are now in the defensive or investigative phase and have a threefold challenge: (a) first you must find and understand the offending provision of the contract (not always as easy as it would appear); (b) once found you must convince your opponent to modify the concept; and (c) come to an agreement as to the exact language, which will accurately memorialize the agreed upon concept. The odds are simply on the side that has developed the standard form.

One of the primary provisions in a contract that deals with liability is the indemnity provision. **Indemnity** is a written promise to secure another against hurt, loss, damage, or exempt such individual from liabilities for engaging in the activities specified in the contract. Often indemnity provisions will have three critical components, **first** is the duty to hold the other party harmless; **second** is the duty to defend the other party; **third** adequate insurance or the ability to otherwise pay for the indemnity and the defense. Think of indemnity as your agreement to pay and the duty to defend as your agreement to hire a lawyer for the benefit of the other party. If you are the party receiving the indemnification it is of paramount importance to investigate the other party's ability to actually indemnify you! The failure to adequately investigate the other party's ability to indemnify you is often, overlooked. Too often I have been called upon to analyze a situation where my client did everything correct from a pure contractual perspective, he has a great contract. My client enjoins numerous rights and remedies set forth in a legally binding agreement, but enforcement of such rights and remedies against a party unable to pay isn't worth much. This problem could occur during the negotiation stage or the administration stage. If discovered during the negotiation stage such matters can be assumed or adequately addressed before you enter into a contract. If discovered during the administration stage your leverage is substantially reduced. Insurance issues can arise under three distinct scenarios: (a) the party never procured insurance in the first instance; (b) the party can no longer afford the insurance called for under the contract; and (c) the party no longer qualifies for the insurance. An indemnity from a party with no ability to indemnify you is worthless!

In most circumstances, parties seek to be indemnified and defended against claims emanating from the acts or omissions of the other party. Here is a simple example. You hire an

architect and an engineer to design a building. In your contract with the architect and engineer you specify that the architect and engineer are to indemnify you against any re-work mandated by the City that does not comply with the Building Codes. After all, that is one of the primary reasons you hired the architect and engineer in the first place. If they make a mistake causing you additional cost it seems fair that they should pay for the harm caused? Unfortunately, many architects and engineers just don't see it that way. They will argue that they will interpret the Building Codes to the best of their ability but they simply cannot assume liability for a City Inspector's different interpretation of the Building Codes. Both arguments are legitimate and can only be resolved via fair negotiation.

Negligence - Tort

Liability for acts and omissions to act when you have a duty to act is another matter and can occur under several theories under the law. The most common of these theories is negligence. Hardly a day goes by when we do not hear about a case which involved the negligence of one party to the detriment of another. Negligence liability is predicated upon many elements; duty, breach of that duty and harm caused by such a breach. This theory of liability is based on the existence of a fictitious person who is known as the "average reasonable man." Unfortunately this average reasonable man is more akin to Superman than any individual that has ever existed on earth. In theory this average reasonable person is anything but average. He never takes his eye off the road, never hits a golf ball crooked, has never tossed anything in such an errant fashion that could harm anyone, has never left a skate or rake in the path of anyone, failed to repair cracks in sidewalks, tears in rugs, immediately cleans up spills, has never said anything at any time that could offend anyone, etc. Yes, this guy makes Clark Kent look like an extreme juvenile delinquent!

The truly unfortunate part of this theory is that we are all negligent from time to time. The only question is whether or not anybody is harmed by our negligence. Recently, I was the recipient of some minor negligence of another. I was sitting at a red-light and the poor driver behind me must have temporarily taken his eye off of the road. I saw him approaching but I had nowhere to go. Although he gave me a pretty good whack there appeared to be no visible damage to the car (late model car with latest bumpers). This individual was already pulling out his wallet and getting ready to provide license and insurance. To say his face was glum is an understatement. I looked at my car saw no damage, felt no pain, end of story. I looked at him said; "No harm no foul." His gloomy face lit up with a big smile and said a big, "Thank you sir!" As I drove off I couldn't help but reflect on how rare that must be. Do I think I did something special? Absolutely not! I know many individuals that would have done exactly the same thing. I just did the right thing. At the same time this fellow human anticipated nothing but grief for his momentary lapse. This invention of the Courts known as "the average reasonable man" just doesn't exist! We all make mistakes from time to time. Our legal system has determined that if you do make a mistake and this mistake causes harm to another you are liable for that harm.

Intentional Torts

Another form of civil liability comes from acts that you intend to do. It doesn't matter whether or not you intended to cause damage or not, it is just sufficient that you intended to do the act. This is known as intentional tort liability, that is you intended to do the act and that act caused harm to a party. It is not necessary that you intended to do harm! On the other hand, negligence is where you didn't intend to do it or did it wrong or forgot to do it and your act or omission caused the other party some harm.

A rather simple example of the difference by and between the two can be illustrated in the situation of a car collision. You are driving down the street and you take your eyes off the road for a minute, you look up and all you see is the rear bumper of the car in front of you. You slam on the brakes but too late, slam; you hit the car in front of you! This is the classic case of negligence and more than likely you will be held liable for the damages caused by this accident. Fast forward 5 minutes, and you are on the side of the road exchanging drivers' license and insurance numbers and the person you rear ended is a little upset at you since you dented his shiny red Yugo (the best babe magnet on the planet)! As a result, he says some rather insulting things to you and asserts a rather distorted view of your IQ, family's heritage and genealogy. To top it off he challenges your mother's virtues! Oops, yep, he went too far he said something about your Momma! You punch him right in the nose. This is known as a battery and not only a criminal act but also imposes civil penalties as an intentional tort, for any damage your punch may cause to his person. Don't worry if you punch like me the damages will be light side!

Just Because Liability - Tort

I must admit that most of my colleagues would cringe at this classification. In the "just because" category are things called vicarious, imputed, constructive, strict and environmental liability. Each of which are just way too technical to treat even lightly in an article of this length. Suffice it to say that it is liability that is imposed for another's acts "just because" and not truly based on fault but based on a "legal fiction." This just because category places liability for engaging in an activity even though you have done everything correct and you are the "average reasonable man." The most common example is to hold an employer vicariously liable for the acts of an employee committed within the course and scope of his/her employment. In this example, the employer may have done everything right and still be held liable for the acts of an employee committed in the course and scope of his employment. On other occasions, this liability is placed upon an individual solely because he is engaging in a hazardous activity. A simple example would be the owning of a Bengal Tiger as a pet. I know each of you can relate to this for who doesn't have at least one Bengal for a pet? For personal reasons you keep Benny the Tiger in your front yard. He is loose to walk around within the confines of your property. It is almost certain that if Benny bites or eats someone you will be held strictly or absolutely liable. Strict or Absolute liability is based on the following elements: (a) high degree of

risk or harm to people, places or things; (b) highly likely that harm can occur if one engages in this activity; (c) no matter what precautions you take the danger still exists; (d) the activity is not one that you commonly see. A few additional examples are: (1) use of explosives in a thickly populated area; (2) use of highly toxic materials; (3) testing of previously untested dangerous equipment; and (4) use of any fire near a highly explosive material.

Last but not the least on this list is environmental liability that is imposed on owners and operators of real property. Although you may be totally innocent, you are liable for the clean up if you own or operator real estate that contains hazardous materials. This liability has spurred the development of an entire industry to perform different environmental tests prior to one's acquisition of real estate and the remediation of contaminated sites.

What type of liabilities do we face in the business world?

When we conduct business each and everyday we face the challenge of a potential liability arising from negligence, intentional conduct, fictions of the law and by assumed responsibilities under contracts. As a general rule, we are not overly concerned with liabilities that arise as an agreement to pay somebody for a service or a product. For the most part these types of liabilities we enter eyes wide open for the opportunity they provide. Although occasionally a business suffers from lack of proper representation and didn't understand what they were agreeing to, for the most part you are a sophisticated businessperson and you only enter into contracts in which you understand the commitment.

What can we do to limit our liability?

Other than absolutely causing no harm or avoiding all activities in which you may be liable pursuant to a legal fiction, in reality you cannot limit your liability! OK, Dennis why have you wasted my time reading this boring article if that is the case? Why should I read on? My time is valuable and what is the use if I cannot limit my liability? That is a good question and the answer is simple, liability exists the only question at hand is can it be transferred, waived or diverted, to others or shielded against?

Your next question is how can we transfer, waive, shield against or divert our liability? Although a more detailed answer to this question shall be provided in future articles, the short answer is:

- Via contract;
- Insurance;
- Specify an optimum dispute resolution process; and
- Create a business entity as a "shield" against liability.

In the purest of senses liability cannot be limited. The ultimate costs associated with liability can be transferred, waived or diverted, to others or shielded against.

SUMMARY

Most would agree, income is good, liability and expenses are bad. In the next few articles we will examine in more detail the methodologies used to limit your liability. The next article will commence a discussion on the more commonly used contractual provisions intended to limit your liability!