



Bulletin

Understanding and Managing Risks Associated with Consequential Damages

INFORMATION

The issue of consequential damages raises many questions. What are consequential damages? When do I need a waiver? What should that waiver look like? What if I can't get a waiver?

When you are looking at a contract for a new project, what is at the top of your list? For most contractors, the number one issue is consequential damages.

Most contractors are concerned about what happens if the project is late or a piece of equipment fails and the facility must shut down. How much will the owner be able to claim? Most owners will want to claim consequential damages, including lost profits or lost revenue.

Ask yourself: how much does the Wal-Mart store make in one day once it opens? How much does a hospital make in one day? One week? One month? These losses can sometimes be measured in millions of dollars per day, a risk that is way too high for the contractor in comparison to the contractor's potential profit.

Staying silent on consequential damages is not a preferred position. In fact, we often hear that if consequential damages are not mentioned in the contract, then there is no liability. This is

just wrong. You must address the issue in the contract with a waiver, or your company will be at risk. If the owner won't give you a full waiver, then the next best thing is to try to limit the exposure through monetary caps or other limiting language.

Consequential damages waivers are included in many industry form contracts, including the AIA forms. These waivers are usually intended to eliminate liability for lost profits, production shortfall and other such damages due to an interruption of the business and make the deal more risk appropriate for the contractor.

TYPES OF DAMAGES

The primary types of damages are **direct** and **consequential damages**.

Direct damages are generally costs that arise naturally and necessarily from a breach of a contract. In construction contracts, direct damages typically refer to an owner's cost to complete the project through a replacement contractor, less any unpaid balance on the original contract.

If the owner is the breaching party, the contractor's direct damages are linked to the increase in its costs to perform the

contract. Direct damages follow naturally from the type of wrong that occurred and are reasonably expected.

For example, the costs incurred by the owner to complete a project following the contractor's default or wrongful abandonment of the project are direct damages. Many times, direct damages are also measured by the costs necessary to repair or replace a contractor's defective work. Similarly, costs incurred to bring a project up to contract specifications have been found to be direct damages.

Consequential damages are generally thought of as losses or injuries that do not flow directly and immediately from the act of the party, but only from some of the consequences or results of such act. Typical examples of consequential damages include lost profits, lost rents, damage to reputation, down or idle time, interest and finance charges, loss of use of goods, additional labor costs, material escalation costs, depreciation, rental costs, additional energy costs, loss of productivity and efficiency, and additional home office costs. The most common and perhaps most costly example of consequential damages in a construction dispute are lost profits.

WAIVERS IN CONTRACTS

Waivers of consequential damages in contracts are one of the most important risk mitigation tools for contracting parties. These waivers are sometimes very robust and clearly describe the damage allocation. Other provisions are vague and can be challenged in court or arbitration.

Owners and contractors in many cases enter negotiation of these waivers from decidedly different views. Contractors tend to view such waivers so that the contractor's potential exposure is proportional to its compensation under

the original contract. Owners, on the other hand, generally believe the contractor should be accountable for damages caused by its failure to manage risks within its control, regardless of the extent of the risks. Moreover, owners may view standard waivers as unjustifiably favoring contractors.

This conflict can be solved by equal and fair allocation of risks to the contractor, which it can successfully and effectively manage, compensation proportionate with those risks, insurance, and offsets to the owner in exchange for an agreement to limit the risks to the contractor under applicable law.

Effective waivers will expressly define the type of consequential damages the provision is intended to bar. Such a provision will allow courts and arbitration panels to dismiss all or part of a construction case at an early stage if the waiver clearly bars a demand for certain types of consequential damages.

However, a broad consequential damages waiver that is improperly drafted may cause contractors and owners to expend significant time and money defending claims that seek damages for delay, lost profits or other damages commonly thought to only be consequential.

When negotiating¹ a waiver of consequential damages one should

¹ Right now you may be asking yourself, how do I start this consequential damages waiver conversation? Negotiation strategies include: (1) making the point that the AIA form contracts include the waiver; (2) telling the Owner that you have priced the job based on known risks and that the revenue of the owner's business is unknown to you; and (3) attempting to convince the Owner that the parties are better off with a reasonable, agreed to liquidated damages amount that can be fairly and predictably assessed by both the Owner and the contractor.

consider the following general principles:

- (1) Attempt to identify each type of risk;
- (2) Identify damages that may result from breaches of a particular contractual obligation;
- (3) Identify damages the parties agree to waive with the greatest precision possible; and
- (4) Place a cap on or limit any consequential damages not waived.

EXAMPLES OF CONSEQUENTIAL DAMAGES WAIVERS

Preferred Consequential Damages Waiver

NOTWITHSTANDING ANYTHING IN THIS AGREEMENT TO THE CONTRARY, NEITHER PARTY SHALL BE RESPONSIBLE OR HELD LIABLE TO THE OTHER FOR SPECIAL, PUNITIVE, EXEMPLARY DAMAGES, INCIDENTAL, INDIRECT, OR CONSEQUENTIAL DAMAGES ARISING FROM OR OUT OF THIS AGREEMENT, OR FOR ANY LOSS OF PROFIT, LOSS OF PRODUCT OR BUSINESS INTERRUPTIONS OR OTHER SIMILAR DAMAGES (WHETHER SUCH DAMAGES ARE CHARACTERIZED AS DIRECT OR INDIRECT), HOWEVER SAME MAY BE CAUSED, INCLUDING THE BREACH OF CONTRACT OR WARRANTY, TORT (INCLUDING NEGLIGENCE), STRICT LIABILITY OR OTHERWISE.

NEITHER PARTY SHALL BE LIABLE UNDER THIS AGREEMENT FOR ANY INDIRECT, SPECIAL, INCIDENTAL, PUNITIVE OR CONSEQUENTIAL DAMAGES (INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS, WORK STOPPAGE, LOST BUSINESS, LOST OPPORTUNITY OR DAMAGE TO REPUTATION), OR ANY

OTHER SIMILAR DAMAGES UNDER ANY THEORY OF LIABILITY (WHETHER IN CONTRACT, TORT, STRICT LIABILITY, STATUTORY, OR ANY OTHER THEORY), EVEN IF THE PARTY HAS BEEN INFORMED OF THE POSSIBILITY THEREOF.

One-Sided Consequential Damages Waiver

NOTWITHSTANDING ANY PROVISION TO THE CONTRARY, IN NO EVENT SHALL SUBCONTRACTOR, ITS PARENT AND/OR AFFILIATED COMPANIES, AND THEIR RESPECTIVE DIRECTORS, STOCKHOLDERS, OFFICERS, EMPLOYEES, ATTORNEYS, AGENTS AND ASSIGNS BE LIABLE FOR ANY INCIDENTAL, CONSEQUENTIAL (INCLUDING LOST PROFITS), SPECIAL, PUNITIVE OR EXEMPLARY DAMAGES IN CONNECTION WITH THE EQUIPMENT OR THIS AGREEMENT, EVEN IF NOTICE WAS GIVEN OF THE POSSIBILITY OF SUCH DAMAGES AND EVEN IF SUCH DAMAGES WERE REASONABLY FORESEEABLE.

Simple Mutual Consequential Damages Waiver

NEITHER CONTRACTOR NOR SUBCONTRACTOR SHALL BE LIABLE TO THE OTHER FOR INDIRECT, SPECIAL, EXEMPLARY, CONSEQUENTIAL OR PUNITIVE DAMAGES.²

Consequential Damages Provisions with Exceptions

COMPANY SHALL RELEASE AND HOLD CONTRACTOR GROUP

² This clause is not preferred since it leaves open the possibility that the Owner will claim loss of use or lost revenue as a direct damage and not a consequential damage.

HARMLESS FROM ANY CONSEQUENTIAL LOSS SUSTAINED BY COMPANY GROUP IN RELATION TO THE CONTRACT, EVEN IF SUCH LOSS OR DAMAGE RESULTS FROM THE NEGLIGENCE OF CONTRACTOR GROUP, BUT EXCLUDING CONTRACTOR'S RESPONSIBILITY WITH RESPECT TO CONSEQUENTIAL LOSS FOR (I) GROSS NEGLIGENCE AND WILLFUL MISCONDUCT OF CONTRACTOR GROUP (II) THIRD PARTY CLAIMS (III) PATENT INFRINGEMENT OR (IV) BREACH OF CONFIDENTIALITY.

Limitation of Liability Provision that would Include a Cap on Consequential Damages

CONTRACTOR'S CUMULATIVE LIABILITY TO COMPANY ARISING UNDER OR RELATING TO OR IN CONNECTION TO THIS CONTRACT OR THE WORK TO BE PROVIDED HEREUNDER SHALL IN NO EVENT EXCEED 15% (FIFTEEN PERCENT) OF THE CONTRACT PRICE, REGARDLESS OF WHETHER SUCH CLAIM OR LIABILITY OR ALLEGED LIABILITY IS BASED OR CLAIMED TO BE BASED ON NEGLIGENCE (INCLUDING SOLE, JOINT, ACTIVE, PASSIVE, CONCURRENT OR GROSS NEGLIGENCE), FAULT, BREACH OF WARRANTY, BREACH OF AGREEMENT, STATUTE, STRICT LIABILITY, TORT OR OTHERWISE.

WHAT IF I CAN'T GET A CONSEQUENTIAL DAMAGES WAIVER?

Proper insurance is a crucial risk management tool for contractors. Insurance coverage for contract clauses seeking to establish damages is complex. In some cases, certain types of damages are not covered by

insurance. Builders Risk, Commercial General Liability, and Professional Liability Insurance may apply to consequential losses. Each of these have elements or can be drafted to include elements that cover direct losses as well as losses arising from those covered losses.

For example, Delayed Completion Coverage, which is typically written as part of a builders risk or marine cargo policy, insures against loss of income or certain specified expenses (such as additional interest charges) that result from a delay in the completion of a construction project beyond the expected completion date.

Other types of insurance may be tied into the definition of property damage in the general liability policy. Sometimes the general liability policy will define property damage to include loss of use. The loss of use is clearly a consequential damage that can be insured.

While it appears that there is some access to the insurance market to insure against consequential damages, the market for broad, stand-alone consequential damages coverage is fairly uncertain. In the limited cases where it is possible to locate coverage for consequential damages, it is often times found that the coverage is very expensive and outweighs the potential benefits.

While the insurance market continues to move in the area of consequential damages, it is preferred to deal with consequential damages directly in the contract as a waiver or through a cap on liability.

STATE JUDICIAL ENFORCEMENT OF CONSEQUENTIAL DAMAGES PROVISIONS

In general, states are in agreement on the enforcement of consequential damages waiver provisions in a contract. Unless a provision addressing consequential damages is unconscionable, i.e., if it is one-sided or harsh, it is generally enforceable. The question, however, remains whether one is liable for consequential damages when a contract is silent as to such a provision.

Hence, a close examination of the laws of Texas, Florida, California, Colorado, and Pennsylvania is necessary. First of all, none of these states preclude a claimant from recovering consequential damages when the contract is silent on consequential damages—meaning it does not include a waiver provision. Nevertheless, the courts in these states differ slightly in their enforcement of waiver provisions.

Texas

Texas courts generally allow parties to make their own contract terms and will not change the deal, except in very extreme situations. For this reason, a party trying to escape liability for consequential damages should always include a waiver provision in the contract. Such a provision, in Texas, may only be denied enforcement if it is unconscionable.

The unconscionability of a contract or clause is measured by looking at:

- (1) The atmosphere in which an agreement is formed;
- (2) Alternatives available to the parties at the time of contracting [only one source];

- (3) The ability of a party not to make changes to the terms;
- (4) Whether the contract goes against public policy, or is illegal; and
- (5) Whether the contract is oppressive or unreasonable.

This is an extremely high standard, and it is unlikely that courts will find that consequential damages waivers are unconscionable.

A typical example of an unconscionable contract is where one party is an experienced dealer in a type of business, while the other party is a newcomer. Assume that the experienced businessman asks the newcomer to sign a contract, and, in order to mislead the newcomer into signing onto unfair terms, the businessman buried a consequential damages waiver provision written in very small font and very complicated, technical language that most people would not understand. In this case, the contract might be declared unconscionable because of unequal bargaining power between the parties, and because the businessman used his knowledge and experience to take advantage of the newcomer.

Florida

Florida essentially applies the same rules to consequential damages waiver provisions as Texas. Florida generally upholds limitations of liability, and consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable.

In addition, Florida, like Texas, does not allow for recovery of punitive damages in actions for breach of contract, even where the breach is willful and flagrant or oppressive.

California

California also allows parties to limit or exclude damages, including consequential damages, unless the provision is unconscionable (same as Texas). California specifically allows a plaintiff to pursue all potential remedies available for breach of contract if a limited remedy clause fails its essential purpose.

This means that courts would question whether the clause fulfilled its purpose and did not prevent a party from receiving what it bargained for. Therefore, if there is no clause in the contract that addresses consequential damages, parties will usually be held liable.

The sole exception to consider, however, is that California determines whether a provision waiving consequential damages can be upheld on a case-by-case basis, taking into account factors such as the parties involved, the allocation of risk, and the precise nature and purpose of the contract.

Colorado

Colorado, absent unconscionability, upholds limitations of liability and specifically allows for limitations on remedies in contracts. Consequential damages are available notwithstanding a provision seeking to exclude them if the provision fails its essential purpose (same as California).

Parties may exclude this possibility by using clear and unambiguous language. For this reason, a contract that does not include a waiver puts parties at risk in Colorado as well.

Pennsylvania

Similar to all the other states examined, Pennsylvania generally enforces limitations of liability clauses for

consequential damages so long as the provision is not unconscionable.

Again, like California and Colorado, Pennsylvania also adheres to the requirement that such provision does not fail its essential purpose.

Nevertheless, if a limited remedy fails its essential purpose, consequential damages may be recovered, despite any clause in the contract excluding them.

Therefore, in Pennsylvania, a party might not only be held liable for consequential damages if the contract does not include a waiver, but it may also be required to pay consequential damages if there is a waiver included in the contract that fails of its essential purpose.

CONCLUSION

It is critically important for contractors to address consequential damages when planning a project. Failure to do so will place the contractor at substantial risk should equipment fail or an incident occurs that causes a significant delay or the project to fail.

Negotiating a consequential damages waiver in a project contract that's fair and balanced for all parties involved is the preferred option. **Be sure to consult with your attorney when entering into contract negotiations to be sure your company's best interests on this issue and others are covered.**

Another potential source of protection for your company against consequential damages may be available through insurance coverage. Delayed Completion Coverage, Builders Risk, Commercial General Liability, and Professional Liability Insurance may apply to consequential losses and are

worth consideration. However, the market for broad, stand-alone consequential damages coverage is fairly uncertain, and where it is accessible, the coverage is very costly and may outweigh the potential benefits.

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