

Limiting Exposure for Consequential Damages

This article will explain the various types of damages which may be recoverable by an owner arising out of a contractor default, and the various ways in which the contractor (and its surety) may limit their liability for these damages.

Damages Recoverable for Breach of Contract

When one party breaches a construction contract, the other party is entitled to compensatory or actual damages in order to place it in the position in which it would have been had the breach not occurred. To fully compensate the non-breaching party, recoverable damages therefore normally include both "direct" damages and "consequential" damages.

Direct or general damages are those damages that arise naturally and directly from the breach. Direct damages are recoverable even if unexpected, because they may fairly and reasonably be considered as arising naturally (according to the usual course of things) from such breach of contract. Direct damages in a typical breach of construction contract action are the cost to complete the construction work less the contract balance, or the cost to correct work which was defectively performed by the contractor.

Conversely, courts award consequential or special damages to compensate for losses that do not result from the ordinary course of events, but were "foreseeable by the party in breach because of special circumstances that he had reason to know when he made the contract." *Restatement (Second) of Contracts* §§ 351(1), (2) (b) (1979). While consequential damage claims on construction projects typically arise out of delayed completion of the project, they can also arise because of other contractual breaches. From an owner's perspective, consequential damages may include loss of use damages, lost profits, increased interest expense, diminution in value, and lost rent income. From a contractor's perspective, consequential damages may include extended home office overhead, lost profits, loss of bonding capacity, and professional reputation. Hence, the consequential damages arising from a breach of contract can, and often do, exceed the direct damages.

The standard of proof to recover consequential damages is higher than that required for recovery of direct damages (for example, the owner must prove that the consequential damages were foreseeable by the contractor because of special circumstances that the contractor had reason to know when he made the contract). Unfortunately, the distinction between direct damages and consequential damages can be difficult to ascertain. Courts have been inconsistent when classifying damages (i.e., direct v. consequential). Furthermore, it is common for sophisticated owners to incorporate contractual language that spells out the types of damages recoverable if the contractor breaches, which effectively establishes that the contractor contemplated those damages at the time of contract formation. As a result, it is incumbent upon the contractor and its surety to be proactive in their efforts to limit their exposure for consequential damages.

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Contractual Waiver of Consequential Damages

One way to limit the consequential damage exposure of the contractor and its surety is by incorporating a mutual waiver of consequential damages clause into the contract. An example of such a clause is found in AIA Document A201-1997, General Conditions, Article 4.3.10:

§ 4.3.10 Claims for Consequential Damages. The Contractor and Owner waive Claims against each other for consequential damages arising out of or relating to this Contract. This mutual waiver includes:

.1 damages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and

.2 damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit except anticipated profit arising directly from the Work.

This mutual waiver is applicable, without limitation, to all consequential damages due to either party's termination in accordance with Article 14. Nothing contained in this Section 4.3.10 shall be deemed to preclude an award of liquidated direct damages, when applicable, in accordance with the requirements of the Contract Documents.

The incorporation of such a clause could result in only partial compensation of a non-breaching contractor in the event of an owner default. Therefore, it is extremely important that the contractor consider whether to limit the scope of the waiver by describing the types of consequential damages waived. Otherwise, a contractor may not fully appreciate the risks that it is taking by entering the contract. A contractor may also want to consider limiting the waiver so that the owner only waives its right to recover consequential damages to the extent those damages are not covered by insurance because it will be easier to obtain a partial waiver from the owner. If the owner is unwilling to waive consequential damages entirely, we recommend that the contractor negotiate a dollar cap on consequential damage exposure.

The value of consequential damage waivers became clear to the construction industry in *Perini Corp. v. Greate Bay Hotel & Casino, Inc.*, 129 N.J. 479, 610 A.2d 364 (1992). A casino owner sued its construction manager for failing to timely complete extensive renovations. Not surprisingly, the owner claimed the loss of significant profits because it could not open on time. The agreement contained neither a consequential damage waiver nor a liquidated damages provision. An arbitration panel awarded the owner \$14.5 million for lost profits due to the contractor's delay. In seeking to set aside the award, Perini argued that lost profits were not reasonably foreseeable. Furthermore, the agreement, which contained "precise remedies for other breaches," did not address the issue of lost profits. The Supreme Court of New Jersey upheld the award notwithstanding that it dwarfed the \$600,000 value of the parties' contract. The court noted that the arbitrators acted within their discretion in deciding that it was reasonably foreseeable that a delay would have resulted in lost profits of this magnitude.

Liquidated Damages

Owners and contractors oftentimes "liquidate" the damages recoverable by an owner in the event a contractor improperly delays the completion of the project. Typically, such clauses stipulate a fixed sum as liquidated damages for each day's delay. The benefit of a liquidated damages provision is that it alleviates the need for an analysis of what damages are reasonably foreseeable. A liquidated damages clause sets a defined, previously agreed upon dollar amount that the aggrieved party may collect for each day (or other defined period) of delay. If the daily liquidated damages amount is reasonable, it is recommended that contractors negotiate to include such a clause in all of their

contracts. A properly drafted liquidated damages clause precludes any award of any actual delay damages to the owner because the owner may not recover actual damages in addition to liquidated damages.

A liquidated damages clause typically covers all delay damages incurred by an owner resulting from a contractor's unexcused delay. However, each liquidated damages clause must be examined closely to ensure that the owner has not attempted to carve out certain types of damages from the clause, such as the one in the example below:

The amount recoverable as liquidated damages hereunder is intended to compensate Owner solely for loss of use during the period of delay. **Such liquidated damages shall be in addition to other consequential losses or damages that the Owner may incur by reason of such delays**, such as, but not limited to, the cost of additional architectural and construction management services resulting from the delay, additional costs to the Owner for payments to other Contractors resulting from the delay, including acceleration costs by other Contractors to recover from the defaulting Contractor's delay.

In the absence of an enforceable liquidated damages clause and to the extent they are not waived, an owner may be entitled to recover all provable actual damages (i.e., both direct and consequential damages) arising out of a contractor's breach.

We also strongly recommend that our contractors negotiate for a cap on the total amount of delay damages recoverable under their contracts. On many projects, the daily amount recoverable as liquidated damages is so substantial that the continued viability of the contractor could be in jeopardy if significant delays occurred for which the contractor is responsible.

Conclusion

When reviewing a construction contract, particularly where the owner expects the project to generate revenue, contractors should evaluate:

1. The risk of consequential damages in the contract. For example, are liquidated damages the owner's sole and exclusive remedy for delay?
2. If liquidated damages are not the sole and exclusive remedy for delay, does the contract contain a mutual waiver of consequential damages?
3. If not, does the contract contain an appropriate cap on the consequential damage exposure?

The best way for a contractor to limit its exposure for consequential and delay damages is to incorporate into all of its construction contracts Mutual Waivers of Consequential Damages and Liquidated Damages clauses. It is also recommended that the contractor negotiate for a cap on the total amount of delay and consequential damages recoverable from it in the event it breaches its contract.

