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Contract Drafting to Reduce or Eliminate Damages – What are the Limits?

Consequential Damages

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Something has gone wrong. The project is in trouble. Everyone is pointing fingers. The damages are staggering and are mounting on a daily, perhaps hourly, basis. The client needs answers: (1) will I be able to recover these losses; and (2) if it turns out to be my fault, what is my exposure? Either way, the question often is really: (3) will I lose my business?

For the construction practitioner drafting the contract, protecting a client with respect to consequential damages is challenging. *Consequential Damage Waivers* are in theory a simple way to manage, allocate, and by definition, eliminate risk for consequential damages. However, whether a *Consequential Damage Waiver* clause will be enforced in any particular situation often depends on how well the contract

describes the intent of the parties with respect to the specific types of consequential damages being waived.

I. Introduction

First, a brief primer. When a construction contract is breached, damages may be recovered. The analysis starts by considering what damages a party is entitled to in the absence of any limitation. Generally speaking, the aggrieved, non-breaching party is entitled to recover losses reasonably foreseeable as a result of the breach. Generally speaking, contract damages do not include recovery of remote losses.

Contract damages are different from tort damages. The law of torts enforces society's desire that its members be free from the harmful conduct of others, while the law of contracts enforces society's desire that promises made between its members be performed. [1] In the law of tort, liability is predicated on fault, and to the extent an injured party establishes fault, the injured party is entitled to collect damages from the wrongdoer for all losses sustained even if the wrongdoer could not have anticipated the ultimate amount or extent of the damages that were caused by the wrongful conduct. This is not the law of contract. In the law of contract, damages are not awarded based on fault but simply based on whether the contract was performed or breached. There is no distinction in damages awarded for breach of contract based on the motivation of the breaching party. Thus, the beginning premise of the law of contract damages is to

[1] *Applied Equipment Corp. v. Litton Saudi Arabia Ltd*, 869 P. 2d 454 (Cal. 1994).

make the party whole, by putting the party in the position that party would have been had the contract been performed.

This fundamental principle is stated succinctly in the comments to ABA Model Jury Instruction §10.02:

> The general understanding of the purpose and limitation of compensatory damages is almost universally accepted… the basic purpose of contract damages is to make a party whole by putting it in as good a position as the party would have been had the contract been performed…a party is not entitled to recover damages not the proximate result of the breach of contract and those which are remote, contingent, and speculative in character. (internal citations omitted)

Within the realm of recoverable breach of contract damages, the law distinguishes between "direct or general" damages, and "consequential or special" damages. Both types of damages are recoverable for breach of contract. Direct damages are routinely defined as those damages that flow naturally and necessarily from the breach and compensate for loss that is presumed to have been foreseen or contemplated by the parties as a consequence of breach. Examples of direct damages are contract balances, and the cost to repair defective work. Consequential damages are losses to the non-breaching party that do not flow directly and immediately from the breach, but only from some of the consequences or results of the breach. Examples of consequential damages are loss of bonding capacity, and loss of working capital. Whether direct, or consequential, the law requires that all contract damages be the natural, probable, reasonably foreseeable consequence of the breach. The "reasonably foreseeable" prong of the analysis is at the heart of any discussion of consequential damages.

The judicially created "rule of reasonableness" originated in the 1854 English decision in *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep 145 (1854). Hadley was the owner and operator of a flour mill. The crankshaft which ran the mill broke. Without the crankshaft, Hadley could not operate the mill. The crankshaft manufacturer was located in another town, and the manufacturer needed the broken crankshaft to make a pattern for the replacement part. Hadley hired a local carrier (Baxendale) to deliver the crankshaft to the manufacturer, and the carrier agreed to deliver it the next day. In breach of this agreement, the carrier did not deliver the crankshaft for five days. Hadley brought suit against Baxendale seeking to recover the lost profits caused by the mill being shut down the additional five days. The court denied Hadley's claim:

> [T]he damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally…from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it… [T]he loss of profits here cannot reasonably be considered such a consequence of the breach of contract as could have been fairly and reasonably contemplated by both the parties when they made this contract. For such loss would neither have flowed naturally from the breach of this contract in the great multitude of such cases…nor were the special circumstances…communicated to or known by the defendants.

Over one hundred and fifty years later, this limitation on damages for breach of contract is still enforced. While both types of damages are recoverable, the burden of proof on the claimant may be different in some jurisdictions. For example, in *Campania Embotellador Del Pacifico, S.A. v. Pepsi Cola Co*., 650 F. Supp 2d 314 (S.D.N.Y. 2009) the court required the amount of consequential damages to be proven "with reasonable certainty" while requiring only a "reasonable estimate" of direct damages. The ABA

Model Jury Instructions For Construction Litigation, §10.04 sets forth the burden of proving causation as follows.

> The proximate consequences of an act or omission are those that follow from the breach in the ordinary course of events. They are the usual consequences that might reasonably have been expected. This is in distinction to remote consequences, which are the unusual or unexpected result, not reasonably to be anticipated from an accidental combination of circumstances or a result over which the defendant had no control. Stated another way, a proximate cause is a "but for" circumstance where the breach is a substantial factor in bringing about the damage.
>
> The plaintiff is required to prove that its damages, if any, were foreseeable to the defendant at the time the parties entered into the contract. This does not mean that the defendant must actually have foreseen the particular loss or damage suffered by the plaintiff. All that is required is that the plaintiff proves by a preponderance of the evidence that a reasonable person in the position of the defendant would have foreseen the harm as a probable result of the breach. Damages are foreseeable if they either follow from the breach in the ordinary course of events or follow from the breach as a result of circumstances that the party in breach had reason to know.
>
> Damages are not recoverable for losses that [the party in breach] did not have reason to foresee as a probable result of the breach when the contract was made.
>
> In establishing proximate causation, plaintiff must segregate any of its damages caused by defendant from those damages caused by third parties or by itself or through no one's fault. If you find that plaintiff has failed to prove what portion of its damages, if any, were proximately caused by defendant, then you may not award plaintiff any damages in this case.

Sophisticated parties familiar with complex commercial construction are uniquely suited to understand, appreciate, and consequentially to "anticipate" the likely far-reaching consequences of a breach. So if the definition of whether damages are consequential turns on whether the damages were reasonably foreseeable at the time the parties

entered into the contract, how do sophisticated parties in the construction industry avoid "consequential" damages at all?

II. Consequential Damages in the Construction Industry

Identifying the types of damages that occur when a construction contract is breached is necessary before those damages can be placed in the categories of "direct" and "consequential". Because the losses suffered by a contractor are different from the losses suffered by an owner, a list will be developed for each.

Contractor damages:

- Contract Balance
- Pending (Unresolved) Change Orders
- Pending (Unresolved) Requests for Time Extensions
- Material Escalation
- Inefficiency
- Overtime/Cost of Acceleration
- Extended jobsite overhead
- Loss of early completion bonus
- Lost Profits on Project work
- Loss of profits on other projects
- Home Office overhead

- Loss of bonding capacity
- Loss of reputation

Owner Damages

- Cost to repair/replace
- Rental expense
- Liability to other contractors
- Extended cost of inspectors, utilities, design professionals
- Finance expenses and carrying costs
- Loss of Use
- Loss of income (rent/sales)
- Lost profits on subject Project
- Lost profits on other ventures
- Diminution in value
- Loss of reputation
- Loss of employee productivity
- Liquidated Damages

While space and time do not permit an exhaustive examination of each of these potential categories of loss, one type of loss occurs with such frequency, and has yielded such staggering awards, as to warrant an individual, special, discussion.

Lost Profits

Lost profits are not easily categorized as "direct" or "consequential". When the non-breaching party seeks only to recover money that the breaching party agreed to pay under the contract, the damages sought are direct damages. The damages may still be characterized as lost profits – had the contract been performed, the non-breaching party would have profited to the extent that his cost of performance was less than the total value of the breaching party's promised payments. In this case, the lost profits are the direct and probable consequence of the breach[2], damages which, in the ordinary course of human experience, can be expected to result from a breach[3].

Conversely, lost profits are consequential damages when, as a result of the breach, the non-breaching party suffers loss of profits on other, collateral business dealings:

> In the typical case, the ability of the non-breaching party to operate his business, and thereby generate profits on collateral transactions, is contingent on the performance of the primary contract. When the breaching party does not perform, the non-breaching party's business is in some way hindered, and the profits from potential collateral exchanges are "lost". [4]

[2] *Tractebel Energy Marketing, Inc. v. AEP Power Marketing, Inc.*, 487 F.3d 89 (2d Cir. 2007)

[3] *Roanoke Hospital Ass'n v. Doyle & Russell, Inc.,* 215 Va. 798, 214 S.E.2d 155 (V. 1975)

[4] *Tractebel*, Id at 109-110.

Determining a contractor's "lost profit" as an element of direct damages has varied from jurisdiction to jurisdiction. For example, In *Lewis Jorge Const. Mgmt. Inc. v. Pomona Unified School Dist*, 102 P.3d (Cal. 2014) the Court held that the contractor's direct damages were limited to its projected profit on the project at issue, measured by the contract price less contractor's cost of full performance, as reflected in its bid. Most courts easily distinguish between profit arising by virtue of a contract balance claim (a direct damage) and a claim of lost profits on other lost business opportunities (a consequential damage), but consider profit as a markup added to claimed delay damages, such as labor escalation costs, or extended jobsite overhead. In *CJ. Langenfelder & Sons, Inc. v. Department of Transportation.* 404 A. 2d 745 (1979), the court rejected a contractor's request for a 10% markup for profit:

> "not only…is there no proof that 10% is a reasonable amount, there is no precedent that we have found supporting it. It must be kept in mind that the claims allowed are not for extra work; they were for escalation of labor costs and indirect expenses incurred as the result of being on the job longer than anticipated. In no case cited ... and in no case examined in our considerable research has the victim of delay caused by the other contracting party been held to be entitled as profits to a percentage of the damage awarded to reimburse him for his additional costs and expenses. Indeed, such a measure of profits would, in the case of a party who had in fact entered into an improvident contract, create a profit where one otherwise would not have been enjoyed."

Consider a sliding scale where direct, recoverable, damages are on one end, and remote, unrecoverable, damages are on the other. In those cases where claims approaching remote (such as loss of bonding capacity) are layered with other indirect claims (such as loss of profit due to loss of future contracts caused by loss of bonding capacity) most jurisdictions almost universally reject the claims as too speculative. See *Lewis Jorge Constr. Mgmt. Inc. v. Pomona Unified School Distr.*, Id. at 266 explaining

that a contractor's loss of potential profits on unearned future construction projects due to impaired bonding capacity is too speculative and thus not recoverable; and *Frenz Enterprises v Port Everglades*, 746 So. 2d 498, (Fla 4th DCA 1999) holding that the trial court did not abuse its discretion in denying a dredging contractor's jury instruction as to lost profits based on an alleged ability to obtain a bond; such damages were not foreseeable.

However, while contractors' claims for lost profits are often categorized as too remote, this is not so frequently the case for owners' claims of lost profit. One of the best illustrations of a contractor being held liable for an owner's lost profits is *Perini Corporation v. Greate Bay Hotel & Casino*, 610 A. 2d 364 (NJ 1992). The project involved the renovation of a casino in Atlantic City, NJ. The Sands purchased the Brighton Hotel in 1981, and in 1983, contracted with Perini to serve as construction manager for a major renovation, with an original Guaranteed Maximum Price of $16,800,000 and a fixed fee for Perini of $600,000. The hotel was a full block from the Boardwalk. The renovation included the construction of "a new glitzy glass façade on the east side of the building which might act as a magnet to lure a new category of customers – strollers who might leave the boardwalk and walk the long block from the beach to the Sands." 610 A. 2d at 485. The renovation was to be completed by May 31, 1984, i.e., in time for the summer season. Although the renovations to the gaming area and the new food court were timely completed and operational, the new entrance and façade were not completed until August 31, 1984, and the entire project was not complete until September 14, 1984, four months late. Three month later, in December,

1984, Sands purported to "terminate" Perini. Perini instituted suit against Sands for contract balance and wrongful termination; Sands counterclaimed for lost profits. The trial court found the claims were subject to arbitration.

The arbitration panel awarded Sands over $14,500,000 in damages for lost profits. The award was affirmed by the trial court, affirmed by the Appellate Division, and ultimately affirmed by the Supreme Court of NJ.

It is this decision that many in the construction industry credit as the catalyst for the American Institute of Architect's inclusion of a mutual waiver of consequential damages in its 1997 revision to the standard *General Conditions for Construction A201*.

III. Waivers of Consequential Damages

The current version of the mutual waiver of consequential damages is found at §15.1.6 of AIA General Conditions A201 (2007):

> § 15.1.6 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 15.1.6 shall be deemed to preclude an award of liquidated damages, when applicable, in accordance with the requirements of the Contract Documents.

Similarly, the *Consensus DOCS 200 Standard Agreement between Owner and Constructor* contains the following mutual waiver at Article 6.6

> 6.6 LIMITED MUTUAL WAIVER OF CONSEQUENTIAL DAMAGES
> Except for damages mutually agreed upon by the Parties as liquidated damages in section 6.5 and excluding losses covered by insurance required by the Contract Documents, the Owner and the Constructor agree to waive all claims against each other for any consequential damages that may arise out of or relate to this Agreement, except for those specific items of damages excluded from this waiver as mutually agreed upon by the Parties and identified below. The Owner agrees to waive damages, including but not limited to the Owner's loss of use of the Project, any rental expenses incurred, loss of income, profit or financing related to the Project, as well as the loss of business, loss of financing, loss of profits not related to this Project, loss of reputation, or insolvency. The Constructor agrees to waive damages, including but not limited to loss of business, loss of financing, loss of profits not related to this Project, loss of bonding capacity, loss of reputation, or insolvency. The provisions of this section shall also apply to the termination of this Agreement and shall survive such termination. The following are excluded from this mutual waiver: _____.

These two provisions illustrate attempts to define and categorize specific items of damages as "consequential" and then to specifically waive each parties respective rights of recovery for these specific damages. Each provision also attempts to identify other related contract provisions that survive this waiver: liquidated damages are expressly excluded (ie, survive the waiver) in both the AIA A201 General Conditions (2007) and the Consensus DOCS 200; both provisions expressly reference application of the waiver in the event of termination; and the Consensus DOCS 200 also stipulates that losses covered by insurance are excluded from the waiver. While both AIA A201 General Conditions (2007) and Consensus DOCS 200 contain waivers of subrogation (in their respective insurance sections) neither expressly refer to those waivers as

surviving the waiver of consequential damages. Side by side, here are the lists of possible damages from earlier in this section, with a notation of whether those damages are expressly waived in these two “standard’ forms of contract:

Owners Damages	AIA A201 (2007)	Consensus DOCS 200
Cost to repair/replace	No	no
Rental Expense	Yes	yes
Liability to other Contractors	No	no
Extended project costs - inspectors, utilities, design professionals	No	no
Diminution in value	No	no
Financing	Yes	yes
Loss of Use	Yes	yes
Loss of Income	Yes	yes
Loss of profits on subject Project	yes	yes
Loss of profits on other business	Yes	yes
Diminution in value	No	no
Business and Reputation	Yes	yes
Loss of Management/employee productivity	Yes	yes
Insolvency	No	yes

Liquidated Damages	excluded	excluded
Termination	Survives	survives
Losses covered by Insurance	Not mentioned	excluded

Contractors Damages	AIA A201 (2007)	Consensus DOCS 200
Contract Balance	No	No
Pending (Unresolved) Change Orders	No	No
Pending (Unresolved) Requests for Time Extensions	No	No
Material Escalation	No	No
Inefficiency	No	No
Overtime/Cost of Acceleration	No	No
Extended jobsite overhead	No	no
Loss of early completion bonus	No	No
Lost Profits on Project work	No	no
Loss of profits on other projects	Yes	yes
Home Office overhead	Yes	no
Loss of bonding capacity	No	yes
Loss of reputation	Yes	yes
Loss of financing	Yes	yes
Insolvency	No	yes

Liquidated Damages	excluded	excluded
Termination	Survives	survives
Losses covered by Insurance	Not mentioned	excluded

IV. For the Construction Practitioner

For the practitioner, perhaps drawing from the strengths of both industry waivers, and supplementing with references to related provisions, is a good starting point. The old adage "hope for the best, plan for the worst" applies in contract drafting at its most basic. The goal should be to create a document that makes sense to the parties it binds, is tailored to the project for which it was drafted, identifies the contemplated risks, and identifies the parties' allocation of those risks as between them. If these basic elements are identified, then if something goes wrong, even terribly wrong, at least the parties will have a chance that the trier of fact might give their agreement the effect the parties intended at the time of their hand shake.

If there is a single practice point for the practitioner drafting a *Consequential Damage Waiver*, it would be to describe and define the specific categories of damages which the parties are stipulating are "consequential" and are agreeing to waive. As stated by a frustrated court in *Gulf American Industries v. Airco Industrial Gases*, 573 so 2d 481 (Fla. 5th DCA 1990) "the term 'consequential damages' is never explained or

clarified anywhere in the contract" and thus the Court had no way of knowing what the term meant and as a result, declined to enforce a *Consequential Damage Waiver*.

It should go without saying that the practitioner should make every effort to avoid defining consequential damages as those damages that are so remote that they were beyond the contemplation of the parties at the time they entered into the contract. Defining consequential damages as losses for which the law does not allow recovery in contract, and then attempting to waive or exclude such damages is counter-productive, to say the least.

V. *Consequential Damage Waivers* – Are they enforceable?

Courts are free to refuse to enforce a *Consequential Damage Waiver* to the extent that grounds exist at law or equity for the revocation of any contract: laches, estoppel, waiver, fraud, duress, and unconscionability. In *State of West Virginia ex. Rel. Johnson Controls, Inc. v. Tucker*, 729 S.E. 2d 808 (W. Va. 2012) an owner sought to avoid the *Consequential Damage Waiver* contained in its A201 (1997) contract on the grounds of unconsionability, arguing that enforcement of the waiver would effectively prevent the Owner from vindicating its rights. The lower court agreed. The Supreme Court of West Virginia reversed noting that the contracting parties "were commercially sophisticated parties familiar with large construction projects" and that while courts are permitted to protect parties from grossly unfair, unconscionable bargains, it is not the

function of the judicial system to "protect commercial litigants from stupid or inefficient bargains willingly and deliberately entered into." 729 S.E.2d at 819-820. Similarly, in *Golden v. Mobile Oil Company,* 882 F2d 490(11th Cir. 1989), the Eleventh Circuit reversed the lower court for finding a *Consequential Damage Waiver* unconscionable, holding:

> A contractual provision is not unenforceable on the ground of unconscionability unless "no decent, fair-minded person would view the ensuing result without being possessed of a profound sense of injustice

882 F. 2d at 793.

There is nothing inherently suspect in the concept of *Consequential Damage Waivers* to warrant concern that the provisions will not be enforced. The courts which have declined to enforce *Consequential Damage Waivers* have not done so because they are "unconscionable" or against public policy – but rather because "consequential" was not defined, and the courts could not ascertain the intent of the parties with respect to what was being waived. See *Gulf American Industries v. Airco Industrial Gases*, 573 So. 2d 481 (declining to enforce a consequential damage waiver because "the term 'consequential damages'…is never explained or clarified anywhere in the contract", the court had "no way of knowing" what the term meant). Where the waiver is clear, it will generally be enforced. See *K.C. Properties of NW Arkansas, Inc. v. Lowell Inv. Partners, LLC* , 373 Ark. 14, 280 S.W.3d 1 (Ark. 2008) (reversed trial court's denial of contractor's claim for profit on extras in accordance with cost plus contract, where waiver of consequential damage provision was for "loss of profits not related to this project"). But see *Tennessee Gas Pipeline Co. v. Technip USA Corp*, 2008 Lexis 6419 (Tex. Ist DCA 2008) where the construction contract provided:

> Article 19.1 Consequential Damages:
> Notwithstanding any other provisions of this Agreement to the contrary, in no event shall Owner or Contractor be liable to each other for any indirect, special, incidental or consequential loss or damage including, but not limited to, loss of profits or revenue, loss of opportunity or use incurred by either Party to the other, or like items of loss or damage; and each Party hereby releases the other Party therefrom.

The Texas appellate court accepted Owner's argument that this waiver only applied to lost profits and loss of use that ***ALSO*** qualified as "consequential", rejecting Contractor's position that the subject contract provision evidenced the parties' intent to define all claims for loss of use and lost profits as consequential.

Finally, in considering possible legal challenges to the enforcement of the *Consequential Damage Waiver*, the practitioner should consider challenges on principles of equity and fair dealing. By specific example, there is a fairly well established body of law dealing with the similar "no damage for delay" clause, creating judicial exceptions to enforcement where there has been active interference, bad faith, gross negligence or fraud on the part of the party seeking to enforce the limiting provision. A good argument could be advanced that these exceptions to enforcement would similarly apply to *Consequential Damage Waivers*, where the facts warranted

VI. Conclusion

In a perfect world, every construction contract would be drafted with words describing the agreement of the parties in such a way that the language used will be interpreted by future readers in exactly the same way as the parties intended. The construction practitioner drafting a *Consequential Damage Waiver* must therefore make

every effort to be to draft the provision is such a way as to accurately and concisely define the damages which are intended to be waived.

The construction industry has made great efforts in its standardized agreements to use plain English, and to include industry jargon only where useful to the contracting parties to define their intent. The term “consequential damages” is not industry jargon; it is lawyer talk. Even among construction practitioners, there is no generally accepted definition of “consequential damages”. If certain types of consequential damages are to be waived by contract, those damages should be defined in terms that are meaningful to the parties, and congruent to the project. Clear and concise language reflecting the intent of the parties will greatly improve the likelihood that a *Consequential Damage Waiver* will be enforced.