

Consequential Damages In Today's Construction Industry

Effectively avoiding them
requires up-front clarity

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It seems unlikely that a project's construction manager, which agreed to a \$600,000 fee, could be held responsible for over \$14 million in lost profits for a four-month delay to the project, yet it has happened. By failing to include a consequential damages waiver in its contract, the construction manager was left open to a costly lawsuit. However, this situation could possibly have been avoided had the construction manager negotiated a clearly worded, project-specific consequential damages waiver.

When a construction contract is breached, two types of damages may be recovered – “direct or general” damages and “indirect or consequential” damages. However, distinguishing between direct and indirect damages has long been a difficult task for courts.

Generally, direct damages follow naturally from the type of wrong complained of. For example, when a contractor fails to complete a project, the costs incurred by the owner to complete the work 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 and foreseeable damages.

Consequential or indirect damages are commonly 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. To be able to recover consequential damages from the breaching party, the damages must have been reasonably foreseeable at the time the contract was made. Typical examples of consequential damages include, among other things, 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.

The ramifications of being held liable for lost profits were best illustrated in *Perini Corporation v. Greate Bay Hotel & Casino*. Perini served as the construction manager for major renovations to the Sands, an Atlantic City hotel and casino. Perini's fee was \$600,000 and its contract with the Sands contained no consequential damages waiver. The project involved the construction of a large ornamental glass façade outside the casino, facing the boardwalk. Although the façade would be nonfunctional, the Sands anticipated that this glitzy display would lure customers away from the boardwalk and into the Sands. The contract called for the work to be substantially complete by May 31, 1984. However, the façade was not completed until August 31, 1984, and the entire project did not achieve substantial

completion until September 14, 1984, approximately four months late.

In an arbitration, the Sands sought from Perini the lost profits it incurred as a result of the delay. Even though the project was only delayed by about four months, the arbitration panel awarded Sands over \$14.5 million in damages, 24 times the contract fee. This amount represented the Sands' lost profits from the end of May until it terminated Perini in December. Ultimately, the New Jersey Supreme Court affirmed the arbitrators' shocking and substantial award.

Perini could have avoided such a harsh result by including a mutual waiver of consequential damages in its contract with the Sands. Contractual waivers of consequential damages have become widespread throughout the construction industry. Indeed, since 1997, the American Institute of Architects has included a mutual waiver of consequential damages in its standard General Conditions for Construction.

Many courts and arbitration panels have dismissed lawsuits without holding a trial based on the presence of a consequential damages waiver. These courts and panels generally find that classification of damages is a legal issue for the courts, and a trial is unnecessary where consequential damages are excluded by contract. Yet, some courts and arbitration panels take an opposite approach to waivers and hold a trial or hearing to decide whether certain categories of damages are consequential.

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These courts find the precise demarcation between direct and consequential damages is a question of fact.

As such, including a clearly worded, project-specific waiver of consequential damages in construction contracts has become critically important in today's construction industry. By defining the scope of consequential damages in the contract itself, parties to a construction contract can increase the likelihood a court or arbitration panel will dismiss a claim without a trial. This was demonstrated in a recent arbitration where

the owner of a large manufacturing facility alleged it suffered over \$15 million in damages because design errors had caused the facility to endure a delayed and extended startup period. These damages included, among other things, costs to remove waste produced during the facility's startup; costs to hire temporary labor to manually move the scrap; costs to hire a back hoe and driver to manage scrap; and costs to pay the facility's staff for months of idleness before the facility was operational.

Nonetheless, the designer's contract with the owner stated: "In no event, however, shall [the designer] be liable on any theory of liability for any special, punitive, exemplary or Consequential Damages." Even more importantly, the contract also specifically defined what the term "Consequential Damages" included:

"'Consequential Damages' shall mean a consequential, indirect or incidental loss or damage, including but not limited to, loss of use, loss of product, loss of replacement power and business interruption."

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Thus, without holding any hearing, the arbitration panel determined that damages for excessive scrap waste, lost product and delay of the facility's start-up were consequential damages. As a result, the panel dismissed the majority of the owner's claims, reducing the amount of damages the owner could demand by over \$10 million.

When defining the scope of a consequential damages waiver, it is important for both contractors and owners to carefully draft the provision in a way that will increase the odds that (i) the parties will not dispute what types of damages are recoverable under the contract; and (ii) if there is such a dispute, the waiver will be found to be enforceable. Both owners and contractors should avoid general boilerplate "catch-all" consequential damages waivers that do not define what the parties mean

by consequential damages. Waivers should be "project-specific" in that they should anticipate and define the potential types of damages that could arise with this project and ensure they are clearly waived. Moreover, the parties should ensure the waiver is mutual, i.e., the list of consequential damages should be the same for the owner and contractor.

While following these recommendations does not guarantee a dispute-free project, following them will minimize the chances of a prolonged litigation regarding what constitutes a consequential damage. ■

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