Waiver of Consequential Damages

By Gail S. Kelley, P.E., Esq.

While a waiver of consequential damages clause is considered a contractual risk management tool, how these provisions manage risk is not always clear. One reason is that potential consequential damages for one or both parties can vary from virtually nothing to many times the contract amount, depending on the project. Engineers often ask whether they should agree to waive their consequential damages, and likewise, whether they should require the other party to waive their consequential damages. The answer, as is common in contract negotiations, is "it depends."

The concept of consequential damages derives from the 1854 English case, *Hadley v. Baxendale*. (Because the United States was a British colony, we inherited many of Britain's legal principles.) The Hadleys were millers who hired Baxendale to transport their broken mill shaft to London for repair. Unfortunately, the repaired shaft was not delivered to the Hadleys by the date the parties had agreed upon, and the mill was shut down for several days. The Hadleys sued for their lost profits but lost, with the court holding that a party injured by a breach of contract can only recover "those injuries which the parties could reasonably have anticipated at the time the contract was entered into." Because the Hadleys had not told Baxendale that the mill operation depended on the shaft, Baxendale could not be held liable for the lost profits.

Over the years, a body of case law has grown around the concept. While many of the cases address specific circumstances and wording, the holding has come to stand for the proposition that a breach of contract can cause two types of damages: direct (or "general") damages and consequential or "special" damages. Direct damages are those required to correct the breach, for example, the cost to correct a design error. Consequential damages are other economic damages suffered by the non-breaching party that the breaching party knew (or should have known) could occur at the time the contract was entered into. They almost always arise from delays in performance; in the context of construction, this typically involves a delay in project completion.

Construction Contracts

One of the best-known cases involving consequential damages arising from construction contracts is *Perini Corp. v. Greate Bay Hotel & Casino, Inc.*, 129 N.J. 479, 610 A.2d 364 (N.J. 1992). In this case, a New Jersey court upheld an arbitration panel's decision that the construction management firm engaged to manage a casino restoration project owed the owner $14,500,000 in lost profits due to delays in the project. It is generally believed that this case was the impetus for adding a mutual waiver of consequential damages clause to the AIA A201. This clause (subparagraph 15.1.7 of the 2017 A201) includes a broad list of the consequential damages that the Owner waives, including rental expenses, loss of use, income, profit, financing, business and reputation, and loss of employee productivity and services. The Contractor waives the right to claim principal office expenses, lost opportunities and profit, loss of bonding or increased bonding costs, and damages to reputation.

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There are two important take-away points from the AIA clause – the first is that there is no universally accepted definition of consequential damages. Therefore, the clause should list the types of consequential damages being waived to avoid dispute. The second is that while nominally mutual, the waiver really only impacts the Owner because the most significant component of any consequential damages is lost profits. Whereas the damages that the Contractor is waiving, including lost profits, are limited and could be difficult to prove, the Owner's lost profits – for example, rental income of apartment or office space – could be substantial. The same holds for an Engineer's contract – although the waiver clause may be mutual, with both parties giving up the right to claim lost profit and business opportunities, the Engineer's potential damages for an Owner breach will generally be limited. However, the mutual waiver appropriately reflects the risk/reward ratio for the parties.

Mutual Waivers

There are no required words that need to be included in a waiver clause, but the clause should be broadly worded to encompass all claims. An example of a commonly used clause is:

> *Engineer and Client waive all consequential damages, including, but not limited to, loss of use, profits, revenue, business opportunity, or production, for claims, disputes, or other matters arising out of or relating to the Contract or the services provided by Engineer, regardless of whether such claim or dispute is based upon breach of contract, willful misconduct, or negligent act or omission of either of them or their employees, agents, subconsultants, or other legal theory, even if the affected party has knowledge of the possibility of such damages. This mutual waiver shall survive termination or completion of this Contract.*

Subcontracts

Parties to a contract can only waive their own rights – they cannot waive the rights of others. This is a key issue for subconsultants – while the Prime Consultant and the Subconsultant may agree to waive consequential damages against each other, if the Owner has not waived its consequential damages and the Subconsultant causes a delay, the Prime Consultant would likely be entitled to pass the Owner's consequential damages down to the Subconsultant.

Conclusion

Engineers generally do not have significant potential consequential damages, so agreeing to waive their own damages typically does not pose much risk. However, the Client's consequential damages that the Engineer could be held liable for will depend on the client, the type of project, and the Engineer's role (prime or subconsultant). Engineers may want to include a mutual waiver of consequential damages in their contracts as standard practice. Since there is no universally accepted definition of consequential damages, the clause should include a comprehensive list of potential damages. When a contract includes a one-sided waiver (where only the Engineer waives damages), the Engineer should request that the waiver be mutual. If the Client balks at a waiver, this might be a red flag for the Engineer.▪

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