A Question of Consequence

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"It's complicated" is the only appropriate response to a client asking about consequential damages and how to recover them (or prevent the other side from recovering them). Whether a particular damage element is consequential or direct simply depends on too much information for any lawyer to confidently opine on without carefully examining, among other things, the entire contractual relationship between the parties and reams of case law. Whether consequential damages are recoverable is also factually complicated and hinges on a bevy of factors, including perhaps some person's subjective beliefs about what the parties anticipated, industry standards or customs, or some e-mail that your client received years ago but has long since forgotten.

Legal arguments over whether damages are direct or consequential damages are, to put it mildly, consequential. Consequential damages waivers were originally incorporated into industry form contracts in response to a $14.5M judgment against a general contractor whose total fee was around $600K. Last September, a federal court held that a general contractor could not pass-down roughly $1.3M in owner-assessed liquidated damages to its subcontractor, because the liquidated damages were not foreseeable and were in any event waived through a relatively boilerplate consequential damages waiver.

The purpose of this paper is to try and shed a flicker of light on an opaque legal subject. The paper begins with a brief history of consequential damages, and their now ubiquitous waiver in construction industry form contracts. Next, the paper sets forth Texas's black letter law on direct vs. consequential damages, along with an analysis of several recent construction case opinions on the subject. Finally, the paper concludes with comments on drafting consequential damages waivers, or alternative clauses more suited to accomplishing your client's goals.

The paper does not address the enforceability of consequential damages waivers for several reasons. First, enforceability of contractual limitations is addressed in more detail by Carson Fisk in his paper on Contractual Limitations of Liability. Second, because Texas courts routinely enforce consequential damages waivers, there is little reason to think that they are subject to special rules regarding their enforcement. The author could find no case treating consequential damages waivers uniquely from other contractual provisions in the commercial or contract context.[1] Where sophisticated parties are concerned, enforceability is

[1] Consequential damages waivers, like all contractual provisions, will not be enforced if they are unconscionable. *McFadden v. Fuentes*, 790 S.W.2d 736, 737 (Tex. App.—El Paso 1990, no writ). One

sometimes conceded. *See, e.g.*, *BCC Merch. Sols., Inc. v. Jet Pay, LLC*, 129 F.Supp.3d 440, 476 (N.D. Tex. 2015).

I. *Hadley v. Baxendale*

Virtually every law student is taught the following case. On May 11, 1854, a grain mill operated by Mr. Hadley and others shut down due to a broken crank shaft. *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854). In order to replace the crank shaft, the mill operators hired Baxendale and Ors to deliver the shaft roughly 110 miles to Greenwich for a fee of two sterlings and four shillings. *Id.* The shaft's engineer was in Greenwich, and would use the broken shaft as a form to create a new one. *Id.* Although the mill staff informed the delivery team to make great haste, "by some neglect" the delivery was delayed, and the return of the new shaft took several days longer than expected by the mill, costing the mill £25 in lost profits. *Id.* Trial Judge Crompton left the matter to the jury without instruction, and they awarded Hadley and his partners full freight on the delivery fee and the lost profits. *Id.*

Adjusted for inflation, the amount in controversy was relatively insignificant; in 2017 dollars, Baxendale's fee was approximately $300, and the mill's lost profits of approximately $3,000. Nonetheless, Baron Sir Edward Hall Alderson, speaking on behalf of the Court of Exchequer, declared that an uninstructed jury in such a case would "manifestly lead to the greatest injustice[,]" and ordered a new trial, with a proper instruction for the next jury. *Id.* In his decision, he set forth a foreseeability element to contractual damages that has come to dominate the American legal landscape. I have included his entire reasoning because, despite 150 years of judicial reflection, Baron Alderson's ruling holds up rather well:

> "Where two parties have made a contract which one of them has broken, the 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, i.e., according to the usual course of things, 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

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narrow exception is that consequential damages waivers governed by the UCC, and applicable to personal injury caused by consumer goods, are "prima facie unconscionable". Tex. Bus. & Comm. Code § 2.719(c). This does not affect consequential damages waivers "where the loss is commercial". *Id.*

> the breach of it. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract. For, had the special circumstances been known, the parties may have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them."

Id. Having laid out the rule, Baron Alderson then essentially decided the case for the next jury: he found that the only thing the plaintiffs had communicated to the defendants was that the plaintiffs were millers and the crank shaft needed to be delivered. *Id.* He hypothesized reasons why the defendants should *not* be presumed to know that operation of the mill was contingent on receipt of the crank shaft, positing that maybe the plaintiffs should have had a spare crank shaft handy, or that other defects in the machinery might otherwise render the delay trivial (an early case of concurrent delays, perhaps). *Id.* Because plaintiffs had not instructed defendants that the mill would be inoperable during the delivery, the Court held that defendants should not be responsible for the mill's lost profits resulting therefrom. *Id.*

Baron Alderson's analysis contemplated two categories of damages, direct and consequential. There is no universal or simple reformulation of the foreseeability requirement, but in general: direct damages are those presumptively foreseen by the parties based on the contract itself and consequential damages are those that would ordinarily follow from a breach of contract based on the demonstrable (i.e. non-presumptive) understanding or special circumstances of the parties. Despite his "baffling" and oft-criticized formulation, Baron Alderson's rule came to dominate contract jurisprudence throughout the United States. *See* PHILLIP J. BRUNER & PATRICK J. O'CONNOR, 6 CONSTRUCTION LAW § 19:16 (*citing* White and Summers, Uniform Commercial Code § 6-1 (5th ed.)).

Why? The rule laid out is less than clear; *Hadley*'s "compendious formula" has been described as meaning "all things to all men." Gilmore, *The Death of Contract* 50 (1974). But it persisted because it hints at an orderly and efficient arrangement of commercial affairs. As Jude Posner put it:

> "[T]he animating principle of Hadley v. Baxendale . . . is that the costs of the untoward consequence of a course of dealings should be borne by that party who was able to avert the consequence at least cost and failed to do so. In Hadley, the untoward consequence was the shutting down of the mill. The carrier could have avoided it by delivering the engine shaft on time. But the mill owners, as the court noted, could have avoided it simply by having a spare shaft. Prudence required that they have a spare shaft anyway, since a replacement could not be obtained at once even if there was no undue delay in carting the broken shaft to and the replacement shaft from the manufacturer. The court refused to imply a duty on the part of the carrier to guarantee the mill owners against the consequences of their own lack of prudence, though of course if the parties had stipulated for such a guarantee the court would have enforced it. The notice requirement of Hadley v. Baxendale is designed to assure that such an improbable guarantee really is intended."

EVRA Corp. v. Swiss Bank Corp., 673 F.2d 951, 957 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982). Regardless, and for our purposes, *Hadley*'s "foreseeability requirement" is the law in Texas, as it has been cited routinely, recently, and approvingly by the Texas Supreme Court. *See, e.g.*, *Basic Capital Mgmt., Inc. v. Dynex Commercial, Inc.*, 348 S.W.3d 894, 902 (Tex. 2011).

The distinction between direct and consequential damages was not especially critical, at least to the construction industry, until the American Institute of Architects began inserting consequential damages waivers into its form contracts, including the following provision placed in the 1997 version of the A201 General Conditions:

> "**§ 4.3.10 Claims for Consequential Damages**. The Contractor and Owner waive claims against each other for consequential damages arising out of 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."

See Am. Inst. Of Architects, Document A201 – 1997.

Most commenters attribute the addition of this consequential damages waiver to the New Jersey Supreme Court's decision in *Perini Corp. v. Great Bay Hotel & Casino, Inc.*, 610 A.2d 364 (N.J. 1992). *See* Benton T. Wheatley and Randy A. Canché, *Navigating the Labyrinth of Consequential Damages in the Construction Industry: A History of and Legal Approaches to Living with Them* from THE CONSTRUCTION LAWYER at 12 Volume 33, Number 3, Summer 2013[2] (describing *Perini* as "the seminal case establishing the creation of waivers of consequential damages"); Mark C. Friedlander, *The Waiver of Consequential Damages in the A201 General Conditions*[3] (describing the AIA's decision as having "been influenced" by *Perini*).

In that case, the Sands Hotel & Casino hired Perini Corporation to act as its construction manager for major renovations to the Brighton Hotel (now known as the Sands Casino Hotel). *Perini Corp.*, 610 A.2d at 366-67. Perini agreed to a $16,800,000 guaranteed maximum price contract with a $600,000 contractor's fee. *Id.* at 367. As part of the renovation, the Sands wanted a $400,000 ornamental, non-functional glass façade fronting the Atlantic City Boardwalk. *Id.* Because the architect's plans for the renovation were not complete when Perini accepted the job, its contract with the Sands had no "time is of the essence" clause. *Id.* Even though the parties had contemplated enacting a schedule once the GMP was agreed upon, that did not happen. *Id.* Instead, sometime during the project the parties agreed to a May 31, 1984 substantial completion date. *Id.* Although the money-making

[2] Available online at http://www.munsch.com/content/editorimages/navigating%20the%20labyrinth%20of%20consequential%20damages%20in%20the%20construction%20industry_%20a%20history%20of%20and%20leg.pdf (last accessed by author on January 24, 2017).

[3] Available online at http://www.schiffhardin.com/Templates/Media/files/archive/binary/design_build-consequential-damages.pdf (last accessed by the author on January 22, 2017).

portions of the Casino were open by the May 31 date, the ornamental façade was not completed until three months later. *Id.* at 367-68.

The case was submitted to arbitration in accordance with the contract, and the arbitrators awarded the Sands $14,500,000 in damages for lost profits. *Id.* at 368. Perini sought to set aside the award on the basis that the lost profits were consequential damages that were not foreseeable under *Hadley v. Baxendale*. *Id.* at 373. The New Jersey Supreme Court upheld the award on the basis that the arbitrators' holding was not "such an egregious mistake that it amount[ed] to an arbitrary remaking of the contract between the parties." *Id.* at 387.

Perini is a strange candidate for industry-wide change. First, the Court affirmed the award reluctantly, relying on the now-uncontroversial proposition that courts should generally defer to arbitrators on the law. *Id.* at 388 ("The theory of lost profits here was most unusual . . . . Our dissenting members, like the dissenting arbitrator below, are not persuaded. The issue, however, is not whether we are persuaded but whether the arbitrators could have been so persuaded without transgressing any of the statutory restraints on arbitral powers."). Second, the case isn't even good law anymore; the "egregious mistake" standard was reversed by the same court just two years later. In *Tretina Printing, Inc. v. Fitzpatrick & Assos., Inc.*, 640 A.2d 788, 792 (N.J. 1994) the New Jersey Supreme Court held that even an egregious mistake of law by the arbitrators would be upheld. (That's basically the law in Texas; manifest disregard of the law is *not* grounds for vacatur under the Texas Arbitration Act. *Hoskins v. Hoskins*, 497 S.W.3d 490, 494 (Tex. 2016).) In other words, the case can be explained entirely on the basis of a runaway arbitration panel without meaningful judicial oversight, something that a consequential damages waiver in the agreement would not necessarily have protected Perini Corporation from anyways.

In any event, the decision triggered widespread fear in the construction industry, mostly directed at the fact that a construction manager assumed a $14.5M liability on the basis of a $600K fee. The American Institute of Architects incorporated its waiver into their next iteration of forms (1997), and the Associated General Contractors followed suit (with slight modifications, discussed below) in 2007. Today, most form contracts include a consequential damages waiver, including the forms promulgated by the Engineers Joint Contract Documents Committees and the Design-Build Institute of America.[4] Carson Fisk's paper in

[4] The DBIA's inclusion of consequential damages appears sincere, since they require users of DBIA forms to waive "consequential damages" against the DBIA "arising out of the use or inability to use DBIA Contract Documents even if DBIA has been advised of the possibility of such damages" as part

your packet materials helpfully includes the various consequential damages waivers contained in the most common industry forms.

II. What are Consequential Damages?

The black letter law on contract damages is well-settled. Contract damages in Texas are either direct or consequential. "Direct damages compensate the plaintiff for the loss that is conclusively presumed to have been foreseen by the defendant from his wrongful act." *Arthur Anderson & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 816 (Tex. 1997). Courts often refer to direct damages as flowing "naturally and necessarily from the wrong." *Id.*; *El Paso Mktg., L.P. v. Wolf Hollow I, L.P.*, 383 S.W.3d 138, 144 (Tex. 2012). If some damage element is *specifically* accounted for in the parties' contract, the damages are by their very nature direct. *McKinney & Moore, Inc. v. City of Longview*, No. 14-08-00628-CV, 2009 WL 4577348, at *5 (Tex. App.—Houston [14th Dist.] Dec. 8, 2009, pet. denied) (mem. op.). Put differently, direct damages are those "inherent in the nature of the breach of the obligation between the parties[.]" *Powell Elec. Sys., Inc. v. Hewlett Packard Co.*, 356 S.W.3d 113, 118 (Tex. App.—Houston [1st Dist.] 2011, no pet.).

By comparison, consequential damages also result "naturally" but "not necessarily" from the defendant's breach. *Stuart v. Bayless*, 964 S.W.2d 920, 921 (Tex. 1998). They are not recoverable unless the parties contemplated, *at the time the parties entered into the contract*, that such damages would be the "probable result of the breach". *Id.*; *see also Mead v. Johnson Grp., Inc.*, 615 S.W.2d 685, 687 (Tex. 1981). Damages are classified as consequential if they "require the existence of some fact beyond the relationship of the parties." *DaimlerChrysler Motors Co. v. Manuel*, 362 S.W.3d 160, 174 (Tex. App.—Fort Worth 2012, no pet.).

The recovery of consequential damages is subject to special rules and factual considerations concerning foreseeability. "Consequential damages are recoverable only if they are foreseeable and directly traceable to the wrongful act and result from it." *Powell Elec.*, 356 S.W.3d at 118. This foreseeability requirement "is a fundamental prerequisite to the recovery of consequential damages for breach of contract." *Basic Capital Mgmt.*, 348 S.W.3d at 901. Texas courts generally look to *Hadley* and its progeny for guidance to determine foreseeability. *Id.* at 901-2. For a more in depth look at the foreseeability requirement, see Section II.c below.

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of their licensing agreement. A draft of that agreement is available at the DBIA's website here: https://www.dbia.org/resource-center/Documents/535_062010.pdf (last accessed by the author on January 23, 2017).

As with much of the law, the legal tests are general guideposts that lose their usefulness in the weeds. In an adversarial system, parties and their lawyers can be expected to sharply disagree about what was or was not the fundamental purpose of the contract or what was actually foreseen or reasonably foreseeable. These determinations will always be made in hindsight after the damages have been suffered, with "a skewed view of what [was] foreseeable at the time of the contract." Ben Wescott and Kenton Andrews, *Stuck in the Middle: A General Contractor's Unique Position in Drafting Liability for Consequential and Liquidated Damages*, CONSTRUCTION LAW JOURNAL at 31, Volume 11, Number 1, (2013).

It is important to keep in mind that the cases construing consequential damages frequently deal with two very similar but distinct issues. In the absence of a consequential damages waiver, *foreseeability* is paramount (because it decides whether unwaived consequential damages are recoverable). In cases where the parties have waived consequential damages, the courts focus on whether damage elements are direct or consequential (because that is dispositive). These analyses frequently get conflated because all damages must be foreseeable to be recoverable. However, if a court is evaluating whether any damage is *foreseeable*, it is a safe bet that the damage is consequential. By definition, direct damages are "conclusively presumed" to have been foreseen, and if a judge is having to labor over that presumption, it probably isn't conclusive.

a. Categories are not always helpful

In an attempt to simplify the law, courts and commenters frequently rely on shorthand categories of consequential damages. So, "[a] classic example of consequential damages is lost profit on collateral business arrangements." John H. Dannecker, Jason W. Hill, John E. Kofron, and Dale B. Rycraft, *Recovering and Avoiding Consequential Damages in the Current Economic Climate*, CONSTRUCTION LAWYER at 29, Volume 30, Number 4, Fall 2010.[5] That's generally the rule in Texas as well. *See Mood v. Kronos Prods., Inc.*, 245 S.W.3d 8, 12 (Tex. App.—Dallas 2007, pet. denied) (classifying "profits lost on other contracts or relationships resulting from the breach" as consequential); *Cherokee Cnty. Cogeneration Partners v. Dynegy Mktg. & Trade*, 305 S.W.3d 309, 314 (Tex. App.—Houston [14th Dist.] 2009, no pet.) (stating that "profits lost on other contracts or relationships resulting from the breach may be classified as . . . consequential damages); *Kiewit Offshore Servs., Ltd. v. Dresser-Rand Global Servs., Inc.*, No. H-15-1299, 2016 WL 4564472, **9-10

[5] Available online at http://shutts.com/wp-content/uploads/2015/09/Recovering-and-Avoiding-Consequential-Damages-in-the-Current-Economic-Climate-1.pdf (last accessed by author on January 24, 2017).

(S.D. Tex. Sept. 1, 2016) (holding that under Texas law damages resulting from third-party contracts were consequential rather than direct).

This classification is useful as shorthand but the devil is in the details. Consider how much work the word "collateral" or the phrase "other contracts or relationships" are doing in those sentences. The definitions presume that the subject matter of the agreement between the parties is wholly separate from the subject matter of other contracts, which of course need not be the case, especially in construction contracts. A flow-down provision obligating a subcontractor to pay its portion of any liquidated damages assessed against the general contractor may well transform those "collateral" or "third-party contract" damages into direct damages. In contrast, the absence of such a provision may result in such damages being classified as consequential or unforeseeable. *See Kiewit*, 2016 WL 4564472, at **9-10 (holding that general contractor could not recover against subcontractor liquidated damages assessed against general contractor because liquidated damages were not foreseeable under the subcontract, and were waived consequential damages in any event); *Longview Constr. and Dev. v. Loggins Constr. Co.*, 523 S.W.2d 771, 777-78 (Tex. Civ. App.—Tyler 1975, writ dism'd) (denying prime contractor's claim against subcontractor for liquidated damages that prime contractor paid owner, because subcontractor did not have actual knowledge of liquidated damages provision in prime agreement).

Damages that are "collateral" and *waived* consequential damages may nonetheless be recoverable under separate, specific provisions in a contract. In *El Paso Mktg., L.P. v. Wolf Hollow I, L.P.*, Wolf Hollow sought "to recover the cost of replacement power it purchased to meet its delivery obligations" to third parties while its gas-fired electric power plant was shut down allegedly due to El Paso Marketing's failure to supply gas. 383 S.W.3d at 140. Because Wolf Hollow waived consequential damages, the Court had to determine whether the replacement-power costs were direct or consequential. *Id.* at 140 n.7. The Court initially declared that Wolf Hollow's "replacement power damages [were] not direct damages" because they did not flow necessarily from the shutdown of the plant. *Id.* at 144.[6] But the Court nonetheless denied summary judgment on the basis of the consequential damages

[6] Wolf Hollow also argued that the contract, including the consequential damages waiver, was governed by the UCC. The UCC's consequential damages waiver provision excludes cover, Tex. Bus. & Com. Code § 2.715(b)(2), which it defines as the purchase of goods in substitution for those due the seller. Tex. Bus. & Com. Code § 2.715(a). The Court rejected this argument on technical grounds, noting that the contract was for *gas*, which Wolf Hollow had replaced with *power*. *El Paso Mktg.*, 383 S.W.3d at 144.

waiver, because other contractual provisions specifically entitled Wolf Hollow to obtain replacement fuels *or power* in its agreement. *Id.* at 145. Note that the Court's decision never explicitly states that the contract rendered the damages direct—the opposite, in fact—but instead simply refused to enforce a broad damages waiver against a specific contractual entitlement.

Lost profits are another area of confusion, because sometimes they are direct, and sometimes they are consequential. "Profits lost on the breached contract itself" are direct damages, but if "a party's expectation of profit is incidental to the performance of the contract, the loss of that expectancy is consequential." *Tenn. Gas Pipeline Co. v. Technip USA Corp.*, No. 01-06-00535-CV, 2008 WL 3876141, at *11 (Tex. App.—Houston [1st Dist.] Aug. 21, 2008, pet. denied) (mem. op.). In that case, which is discussed in more detail below, the owner sought profits it expected to make through the sale of gas to its customers, which it was deprived of allegedly due to delays and defects in the construction of its pipeline. *Id.*, at *11. Even if a party's "primary benefit of the bargain expectations" are profits lost on separate contracts, they may not be direct damages unless actually reflected in the parties' contract. *See BCC Merch.*, 129 F.Supp.3d at 476 (holding that mere sporadic reference to party's separate merchant accounts was not sufficient to make profits lost on such accounts direct, where contract did not specifically provide remedy for those lost profits).

Categories are useful as a starting place but not as an ending place. Whether any damage is direct or consequential will depend primarily on the *actual contract language*.

b. Case studies: direct vs. consequential[7]

There is no simple way to present how courts delineate between direct vs. consequential damages because the determination is often fact or contract specific, and the applicable legal rules are vague. This has "led to inconsistent case law that fails to provide the construction industry or its practitioners with useful analysis" of construction participants' damages with "clarity or a bright line rule". Ben Wescott and Kenton Andrews, *Stuck in the Middle: A General Contractor's Unique Position*

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[7] Obviously these are not the *only* construction cases concerning consequential damages. Other decisions, like *RAJ Partners, Ltd. v. Darco Constr. Corp.*, 217 S.W.3d 638 (Tex. App.—Amarillo 2006, no pet.) and *Wade & Sons, Inc. v. Am. Standard Inc.*, 127 S.W.3d 814 (Tex. App.—San Antonio 2003, pet. denied) have important and construction-specific holdings. But they have also been examined thoughtfully by others. *See, e.g.*, Ben Wescott and Kenton Andrews, *Stuck in the Middle: A General Contractor's Unique Position in Drafting Liability for Consequential and Liquidated Damages*, CONSTRUCTION LAW JOURNAL at 32, Volume 11, Number 1, (2013).

in Drafting Liability for Consequential and Liquidated Damages from CONSTRUCTION LAW JOURNAL at 31, Volume 11, Number 1, (2013). To try and add some much-needed clarity, I have selected seven construction cases (five of which are from Texas) involving consequential damages waivers that specifically delineated particular types of common construction damages as direct or consequential. The results may appear idiosyncratic but hopefully the exercise will provide readers some insight into how courts will analyze this difficulty legal determination.

i. *Reynolds Metals Co. v. Westinghouse Elec. Corp.*, 758 F.2d 1073 (5th Cir. 1985).

Although this is an older case, I have included it here because the holding depended on a very specific understanding of what the parties had agreed to do, and what they were alleged to have not done. It serves as a nice reminder that, where consequential versus direct damages are concerned, details matter.

Reynolds hired Westinghouse Electric to manufacture a large electric transformer unit for use in Reynolds plant. 758 F.2d at 1074. The contract had an exclusive remedy provision in addition to the following consequential damages waiver:

> "Neither party shall be liable for special, indirect, incidental or **consequential damages**."

Id. at 1074, n.1 (emphasis added). The parties' contract contemplated a one-year warranty on the transformer, which the parties extended by amendment. *Id.* at 1075. Importantly, the warranty extension was conditioned on "inspection of all equipment prior to start-up, and start-up supervision by the Westinghouse Industrial Systems Department." *Id.* Reynolds hired a local engineer to supervise the installation of the transformer into Reynolds' plant. *Id.* Westinghouse in turn sent its own engineer to finally inspect and check the start-up of the unit. *Id.* Westinghouse's engineer "apparently failed to install properly the system for detection of ground current in the transformer." *Id.* The transformer failed less than a year after it was installed, despite having a purportedly 20 to 30 year lifespan. *Id.* Although there were dueling allegations concerning the cause, Reynolds' expert opined that a properly installed ground current detection system would have detected the damage in time to prevent or mitigate it. *Id.* Reynolds sent the transformer to Westinghouse for repair, and Westinghouse denied the warranty on the basis that the warranty had expired. *Id.* at 1075-76. Reynolds sought $109,284.82 in damages for the cost to repair the transformer. *Id.*

In construction cases, repair costs are often treated as (or assumed to be) direct damages. Construction contracts routinely address performance standards that speak directly to how the work will be performed, and the inclusion of such language may render repair costs (that is, the cost to bring the good up to the stipulated standard) as direct. *See Spectro Alloys Corp. v. Fire Brick Eng'rs Co.*, 52 F.Supp.3d 918, 931 (D. Minn. 2014). Construction contracts also frequently include specific remedies relating to repairing defective work, which similarly can render repair costs direct. *See McKinney & Moore,* 2009 WL 4577348, at *5; *Powell Elec.*, 356 S.W.3d at 119 (holding that parties could be conclusively presumed to have foreseen that party's "substandard performance would result in the failure of the transformer and that failure of a transformer would require [the other party] to incur" repair costs).

But that isn't what happened in *Reynolds*. The Fifth Circuit held instead that the repair costs were consequential, and therefore waived. *Reynolds Metals Co.*, 758 F.2d at 1079. The Fifth Circuit relied on the UCC, which provides that the appropriate measure of damages is the difference in value between the goods as accepted versus the goods as warranted. *Id.* at 1080; Tex. Bus. & Com. Code § 2.714(b). The court construed the "goods" as "the fee that would have been charged Reynolds by a competent and properly prepared service engineer less the market value of the services" provided by Westinghouse's engineer. *Id.*

How can the holding be explained? Although Reynolds had alleged that the failure resulted from Westinghouse's improper design of the transformer, the trial court had separate grounds for denying Reynolds' recovery, including the fact that the warranty claims were untimely. *Id.* at 1075-77. As a result, the only claim that Reynolds could maintain was a breach-of-contract claim premised on Westinghouse's failure to supply a "competent" engineer "to supervise" the installation of the equipment. *Id.* With only that service claim remaining, the court settled on the difference-in-value measure of damage, probably motivated by concerns about Reynolds' theory of causation. *Id.* at 1077 (stating that "causation problems aside", cost of repair was not the appropriate measure of damages).

The takeaway from this case is that it highlights why categories can be unhelpful. As attractive as cost of repair is as a direct damage resulting from a contract for the delivery and installation of a product, it matters what caused the alleged breach. Here, all that was left was the purported failure to provide a competent engineer, and so the conclusively presumed benefit of such service was not a functioning transformer, but the value of a competent engineer.

ii. *Tenn. Gas Pipeline Co. v. Technip USA Corp.*, No. 01-06-00535-CV, 2008 WL 3876141 (Tex. App.—Houston [1st Dist.] Aug. 21, 2008, pet. denied) (mem. op.).

Despite being a memorandum opinion, *Tennessee Gas Pipeline* significantly shaped the direct versus consequential damages landscape in Texas. The court interpreted the consequential damages waiver narrowly, so that even when parties specifically identified categories of damages they intended to waive, the waiver would only apply to consequential damages within those categories. The case also involved a dozen different damage elements, nearly all of which were threatened on the basis of waiver. The detail in the court's analysis varied wildly, but still provided an instructive opinion relied on repeatedly by future courts and commenters.

TGP owned a gas pipeline and hired Technip to provide improvements under an Engineering, Procurement, and Construction Contract. *Tennessee Gas Pipeline*, 2008 WL 3876141, at *1. The project was delayed and TGP asserted numerous categories of damages against Technip for the delays. *Id.* The jury found that Technip had breached the contract, and awarded delay damages on these elements in the following amounts:

1. Project delay costs, sustained in the past - $4,030,672.07;
2. Excess gas use differential costs, sustained in the past - $4,617,717.00;
3. Excess lube oil costs, sustained in the past - $233,933.04;
4. Excess labor costs, sustained in the past - $950,560.94;
5. Extra power at Station 63 costs, sustained in the past - $30,540.23;
6. Backup generator costs, sustained in the past $34,871.69;
7. Allowance for funds used during construction, sustained in the past - $6,427,535.70;
8. Premature energization costs at Station 54, sustained in the past - $452,368.13;
9. Realignment of compressor costs - $964,170.02;
10. Excessive blowdown costs, sustained in the past - $14,160.00;
11. Replacement and installation of operable oil fill system and repair costs for air dryers, sustained in the past - $156,292.91; and
12. Review "as-build" drawings, to be reasonably sustained in the future - $555,540.00.

Id., at *4. The parties had also agreed to the following consequential damages waiver:

> "*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."

Id., at *3 (emphasis added). On Technip's motion, the trial court reduced the jury award, taking away several of the categories of damages found by the jury. *Id.*, at *1. Both parties appealed, predictably with very different understandings of whether damages categories were direct (and recoverable) or consequential (and therefore waived). *Id.*

As an initial matter, Technip argued that the parties intended to waive consequential damages and *any* damages relating to loss of opportunity, loss of use, lost profits, lost revenue, and "like items of loss or damage." *Id.*, at *7. Technip's argument was that since the parties had included those items into the waiver, they intended to incorporate into their own definition of "consequential damages" those items. *Id.* The court did not agree. After reviewing the entirety of the contract and finding provisions under which Technip had assumed certain risks that arguably included damages falling under the enumerated categories, the court summarily concluded that the consequential damages waiver "did not preclude the recovery of direct damages involving loss of us, opportunity, or profits." *Id.*, at *8. The court then turned to each of the elements of damages.

1. "Project delay costs"

These damages involved TGP's extended administration costs and expenses for labor, travel, environmental contractors, in-house inspectors, additional construction "consumables", wastewater hauling costs, and services and utilities. *Id.* The court held that these "clearly" were direct damages because the contract specifically obligated TGP, as part of its "Owner's Responsibilities," to provide permitting, construction and permanent power, and other personnel to the project site. *Id.* The court reasoned that since TGP was responsible for these costs during construction, any delay caused by Technip would naturally and necessarily require TGP to continue its administration during the delay period. *Id.*

2.-4. Loss of efficiency-excess gas, oil, and labor

TGP characterized these three elements as excess damages resulting from "loss of efficiency caused by the delay" and "lost value." *Id.*, at *9. The damages were the difference in value between what TGP anticipated it would have to pay had Technip installed some compressors on time versus the costs TGP actually had to pay due to the delay. *Id.* TGP contended these were "direct" damages because "the entire reason for the Project" was to timely receive the compressors. *Id.* Without much analysis, the court briskly concluded that the damages were consequential because they were "too remote" to have been conclusively within the contemplation of Technip for any delay. *Id.* Although it is difficult to discern much about the court's basis, it did load the deck by describing the damages as "loss of anticipated savings on the projected efficiency of the new compressor components." *Id.*

5. "Power at Station 63"

The court lumped this in as a direct damage under its "Project delay costs" analysis, making it a direct damage. *Id.* Power at Station 63 was simply a subset of TGP's express contractual obligation to provide power at the construction project. *Id.* If it isn't apparent already, where a contract imposes an obligation directly on a party, a party's expenses to meet that obligation by reason of the other side's breach are very likely going to be direct damages.

6. Backup generator at Station 47

Technip allegedly dismantled an existing backup generator at Station 47 before a new one was fully functional. *Id.* After a power outage, which otherwise would have been mitigated by a functioning backup generator, TGP was forced to *rent* a backup generator to maintain ongoing operations and comply with energy regulations. *Id.* TGP argued that the damage was direct, relying on a contractual clause requiring Technip "to ensure that its work did not 'unreasonably interfere with the operation of the Facilities.'" *Id.*

Without much analysis, the court simply concluded that the damages were consequential. *Id.*, at *10. It is likely that the court thought the causal chain was simply too attenuated, holding that it was not willing to conclusively presume "that a power outage and the necessity of a rented backup generator" was in Technip's contemplation at the time of the contract. *Id.* Since direct damages are defined by this conclusive presumption, the takeaway is that close questions/ties probably go to consequential damages. If you cannot point to a provision in a contract that

expressly entitles your client to, or obligates your opponent to pay, the damages, they may well end up as consequential (and waived).

7. Allowance for funds used during construction

The stated damages are misleading; here TGP was seeking "loss of borrowing power" on interest TGP *might* have accrued on money it otherwise had to invest into the project during delay periods. *Id.* The court characterized this as an "indirect loss" because it depended on "theoretical investments TGP might have made". *Id.* Predictably, the court concluded that these were consequential damages and therefore waived, analogizing to "profits lost on other contracts or relationships resulting from the breach". *Id.* (*citing Cont'l Holdings, Ltd. v. Leahy*, 132 S.W.3d 471, 475 (Tex. App.—Eastland, 2003, no pet.).

8. Premature energy costs at Station 54

TGP had a separate contract with a utility company that required it to pay a specified amount for electric use, subject to a three-month grace period. *Id.* After the grace period, TGP was obligated to either pay for the electricity or 50% of the anticipated electricity that it wasn't using. *Id.* TGP asserted that Technip prematurely requested power to Station 54, but Technip's delay moved TGP out of the three-month grace period, resulting in TGP having to pay the utility company more than it expected. *Id.*

The court held this was a consequential damage because nothing in the contract governed Technip's responsibility for the claim. *Id.* In any event, the court also held it was consequential damage categorically, because "it involve[d] a relationship outside of the Contract between TGP and Technip"—*i.e.* the utility company. *Id.*

10. Excessive blowdown[8]

This damage element was factually complicated. Technip allegedly failed to store certain components properly on its job sites, causing rust to form inside the components. *Id.*, at *11. When TGP finally introduced gas into the pipeline system, some of the pipe's seals were damaged, and other pipeline elements were not properly tightened. *Id.* As a result, TGP had to vent the gas in the pipeline, and perform emergency shutdowns that wasted product. *Id.* TGP sought the value of

[8] Observant readers will ask where damage category 9 went. The court did not address damage elements 9, 11, or 12 based on the waiver of consequential damages, because it held that TGP could not recover them on other grounds. *Id.*, at *23.

this wasted gas (vented, leaked, or not delivered during shutdown), which TGP would otherwise have sold to its customers. *Id.*

The court construed TGP's claim as one for lost profits, and engaged in a wholly typical lost profits/consequential damages analysis—*i.e.* profits lost on the contract itself are direct, but profits "incidental" to the contract are consequential. *Id.* The court concluded that expected profits on sales to customers were incidental, because its contract with Technip was for the "installation of new equipment" and not the sale of gas to customers. *Id.*

Tennessee Gas Pipeline Co. has been written on extensively and is accumulating some gray hairs. I have included it here not to break any new ground, but because it helpfully compartmentalized several different types of claims. Importantly, the only damages that the court held were direct involved costs *expressly* imposed on the owner through the contract. When your client asks you whether they should waive consequential damages, consider that the entire universe of their damages may now live in the four corners of their contract.

iii. *Powell Elec. Sys., Inc. v. Hewlett Packard Co.*, 356 S.W.3d 113, 118 (Tex. App.—Houston [1st Dist.] 2011, no pet.).

Most owner clients would be surprised to find out that a consequential damages waiver eliminated their repair damages, as occurred in *Reynolds*. I have included *Powell Elec. Sys., Inc.* as a counterweight to that holding.

HP owned a manufacturing facility in Houston that had its own power substation. 356 S.W.3d at 116. The substation operated on a two-transformer power system, and HP hired Powell to perform breaker retrofitting services on the substation. *Id.* Powell was required to remove breaker cables and then reconnect them, but apparently did not document which breaker cables it had removed, and as a result unintentionally crossed certain breaker cables on reconnection.[9] *Id.* Because of the crossed breakers, one of the two transformers on the substation failed. *Id.* HP incurred two elements of damage: (1) cost of repair to the failed transformer and (2) costs associated with obtaining a temporary transformer to use during the repairs. *Id.* The parties had agreed to the following consequential damages waiver:

> "NEITHER PARTY SHALL BE LIABLE FOR ANY CONSEQUENTIAL DAMAGES (INCLUDING WITHOUT

[9] This happens to me every time I jump my car.

LIMITATION, LOST PROFITS AND UNLIQUIDIATED INVENTORY), INDIRECT, SPECIAL OR PUNITIVE DAMAGES EVEN IF THE OTHER PARTY HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES."

Id. at 117 n.1 (emphasis added). The jury awarded HP $747,770.63 in damages to repair the broken transformer and $178,815.41 in damages relating to the use of a temporary transformer.

With respect to the repair costs, Powell argued that the direct damages "should be limited to the cost of uncrossing the wrongfully crossed cables or the difference between the value of Powell's actual services and the value of the services promised by Powell[,]" largely in reliance on the *Reynolds* decision. *Id.* at 119. The court rejected the argument, distinguishing *Reynolds* on the grounds that the claim at issue, due to limitations, was merely Westinghouse's improper installation, which was a step removed from the causal element of the damaged transformer (its design defect). *Id.* at 121. The court also held that the damages to the transformer were "inherent in the nature" of Powell's "substandard performance". *Id.* The court was persuaded by the fact that Powell's contract specifically included its obligation to disconnect and reconnect the breaker cables, and the fact that the contract expressly contemplated that Powell would pay for the "[c]osts of repairing or correcting . . . work damaged". *Id.* at 119 n.3.

However, the court held that HP's damages relating to a replacement transformer were consequential. *Id.* at 121. The court relied primarily on the fact that although HP's power substation was a "two-transformer system," "the evidence demonstrate[d]" that the substation could run with only one transformer for some period of time. *Id.* Indeed, the fact that substation could run on one transformer "was a necessary part of Powell's performance of its work" since Powell had planned to operate on one of the transformers while the substation remained operational. *Id.* Accordingly, the court declined to "conclusively presume[]" that the transformer rental damages were direct. *Id.*

Cost of repairs should ordinarily be direct damages in construction disputes, since most construction contracts address the issue expressly. However, if your client anticipates repair costs for defective work (and owners always expect that), incorporate that expectation directly into the contract, especially if consequential damages are waived.

iv. *Balfour Beatty Rail Inc. v. Kan. City S. Ry. Co.*, No. 3:10-CV-1629-L, 2012 WL 3100833 (N.D. Tex. July 31, 2012).

Earlier I had said that courts often conflate a direct versus consequential analysis with a foreseeability analysis, or at least foreseeability elements. This case presents a perfect case study in that conflation because the court treated damages as being consequential (rather than direct) based on the evidence available about the parties' actual knowledge of the damages at issue. As you read through the analysis, compare it to the *Tennessee Gas Pipeline* decision, which focused its attention on contract language rather than the subjective knowledge of the contracting parties.

KCSR purchased a railway track line and engaged a contractor to perform construction and rehabilitation work on roughly 70 miles of railway track line. *Balfour Beatty Rail*, 2012 WL 3100833, at *1. Unhappy with its original contractor, KCSR hired BBRI to complete the work. *Id.* The contract contained a "time is of the essence" clause, along with three milestone deadlines, all in May 2009. *Id.* BBRI commenced work in November of 2008 but did not complete the project until July 2009, after the contractually contemplated deadlines. *Id.*, at *2. BBRI argued that the delays were caused by unknown or unreported site conditions. *Id.* BBRI sued for work performed, and KCSR countersued for various costs relating to BBRI's work. *Id.* at *1. The parties had respectively waived consequential damages through the following clause:

> "**Limitation on Damages**
>
> Neither party will be liable to the other for **consequential**, indirect, or punitive damages for any cause of action, whether in contract, tort or otherwise. **Consequential damages include, but are not limited to, lost profits, lost revenues, and lost business opportunity, whether the other party was or should have been aware of the possibility of these damages**."

Id. at *19 (emphasis added).

Through its counterclaim, KCSR sought $1,133,373.97 in "trackage right fees incurred by KCSR in using another third party's tracks as a result of BBRI's failure to timely complete the project within the time specified by the parties' contract." *Id.* at *1. BBRI moved for summary judgment on this element of damage, arguing that it was a consequential damage waived by KCSR. *Id.* at *17. KCSR countered that the damages were direct because the contract contained a time is of the essence

clause, and because KCSR had published a newsletter on its website that the deadline was critical in order for KCSR to avoid having to pay to pay to use another company's railway tracks. *Id.* at *18.

The court agreed with BBRI that the trackage fees were consequential damages, largely on evidentiary grounds. *Id.* at *19. The court held that there was "no evidence from which the court [could] conclude that the loss of use damages sought by KCSR" were direct, because there was no evidence that BBRI had actual, subjective knowledge of the published newsletter at the time BBRI entered into the contract. *Id.* Nor was there any evidence that BBRI was actually, subjectively aware that KCSR was using or intended to use a competitor's tracks. *Id.* The court specifically rejected that a "time is of the essence" clause made any delay damages direct, because the contract said "nothing about the potential consequences to KCSR for BBRI's failure to complete" the construction on time. *Id.* The court also credited the fact that the trackage fees were damages paid "to [a] third party", citing several Texas cases, including *Tennessee Gas Pipeline* and *Powell Elec.* for the proposition that profits lost on other contracts were consequential. *Id.* Importantly, the parties also had a liquidated damages provision that applied only to a specific subset of specific, potential delays that were not at issue in the case. *Id.*

Although the court relied on a lack of evidence to support its holding, it is not clear why BBRI's actual, subjective knowledge should necessarily have changed the outcome. The consequential damages waiver on its face precluded damages for lost profits, lost revenues, and lost business opportunity even if BBRI "*was . . . aware of the possibility of [such] damages*." *Id.* And direct damages are those that are "conclusively presumed to have been foreseen"—not those that are *actually* foreseen. The court's subjective awareness holding reads much more like a foreseeability analysis used to determine if consequential damages are recoverable absent a waiver, rather than a consequential versus direct damages determination. (See Section II.c.ii., below.)

In any event, the case presents at least two important issues. First, parties may not be able to transform all delay damages into direct damages simply by inserting a "time is of the essence" clause. The mere fact that the parties had a schedule in mind will not preserve all delay claims in the face of a consequential damages waiver. Something more may be necessary, including specific reference to the *type* of delay or resulting damage contemplated under the contract. Second, in the absence of contractual language expressly entitling your client to the damages at issue, anticipate having to present evidence of actual knowledge of the delay or

damages suffered. Failing that, at least have some evidence of reasonable notice (i.e. objective knowledge, see Section II.c.ii., below) of the damages at issue.

v. *Spectro Alloys Corp. v. Fire Brick Eng'rs Co.*, 52 F.Supp.3d 918 (D. Minn. 2014).

Spectro Alloys is not a Texas case, but it is recent. The case involved a relatively standard cost of repair damage model, along with a claim for lost profits from the premature failures resulting from a contractor's work.

Spectro was the owner of an aluminum smelting facility that contained two large furnaces (Furnaces 1 and 3). *Spectro Alloys*, 52 F.Supp.3d at 922. Spectro hired FBE under three contracts to provide replacement lining for Furnace 3, patching to Furnace 1, and replacement "refractory," a material lining the furnaces. *Id.* In all three contracts, FBE had agreed to warrant that its work would be done competently and free from defects, and would correct any deficiencies in its work. *Id.* However, the warranty contained the following consequential damages waiver:

> "NOT INCLUDED UNDER WARRANTY—Normal wear and tear of materials and/or equipment . . . **OR ANY OTHER CONSEQUENTIAL DAMAGES**.

Id. (emphasis added).

Furnace 3 failed and was eventually shut down so that FBE could attempt repairs. *Id.* at 923. The cause of the failure was disputed, and Spectro eventually hired FBE to tear out the refractory material that FBE had previously installed. *Id.* Spectro subsequently refused to pay FBE for the repair work, asserting that FBE's original installation was the cause of the failure, and that the repairs were covered by the warranty. *Id.* After FBE refused to accept the repair work under its warranty, Spectro sued FBE, alleging that both furnaces were prematurely failing, and sought damages for the replacement costs of both furnaces, as well as the value of lost production during the repairs and replacement. *Id.*

FBE moved for summary judgment, characterizing the "repair and replacement costs" as "refunds" performed by "third parties", making them waived consequential damages. *Id.* at 931. The court disagreed and held that because FBE had guaranteed that its work would be done in a competent matter, "*any* repair or replacement work stemming from failures in workmanship [were] direct damages." *Id.* (emphasis added).

FBE also moved for summary judgment on Spectro's claims for "production . . . lost due to the alleged premature failure of the refractory linings." *Id.* The court agreed, holding that "lost profits" were consequential damages generally, because "lost profits are consequential damages that are generally recoverable for breach of warranty under the UCC." *Id.* at 931.[10] Although Spectro argued that the consequential damages waiver should be read narrowly to permit lost profits, the court disagreed, noting that the parties were "sophisticated commercial entities engaged in arms-length transactions." *Id.* at 931.

Contrast the court's holding with respect to the "competent manner" warranty provision with the *Balfour Beatty Rail* holding concerning a "time is of the essence" provision. Here, the court held that because FBE had agreed to perform the work to a particular *standard*, any damages resulting from the failure to perform to that standard were direct. Whereas in *Balfour*, the fact that the contractor had agreed to perform the work *timely* did not render any delay damages direct. Although every contract case is unique to its facts, it is difficult to reconcile the two courts' disparate treatment of contractual standards.

The court's decision to deny lost profits can probably be adequately explained by nuances in Minnesota law, or its application of the UCC. But even if this same case arose in Texas, the question would be whether the lost profits that Spectro sought were for *this* contract, or profits on *other* contracts. I do not know what the result would be. I can imagine a court holding that a contract to provide for the construction or installation of furnaces, that expressly contemplated that the furnaces would be used to produce smelted materials for sale, might mean that lost profits were direct. But in this case FBE's scope was to provide routine maintenance and repair to furnaces that, by their very nature, deteriorate over time. Under those circumstances, it is not apparent, at least to me, that the inherent nature of the contract is profit on the furnaces. I mention this only because it is possible that *repair* contracts could be treated differently than *original construction* contracts. As always, the thought and care that the parties (or their lawyers) put into the contracts themselves will be most determinative over any direct versus consequential damages dispute.

Finally, note that the court relied on the parties' sophistication not just for the *enforceability* of the consequential damages waiver, but to determine its *scope*. The parties' sophistication seemingly contributed to the court's conclusion that

[10] It is interesting that the court would rely on the UCC's definition of consequential damages, as earlier in the opinion the court had declared that the UCC did not apply to FBE's contracts because they were primarily for services rather than goods. *Id.* at 925.

Spectro "clearly agreed" that it would not make claims for "lost profits", even though "lost profits" was not referenced in the waiver itself. *Id.* at 932.

vi. *Kiewit Offshore Servs., Ltd. v. Dresser-Rand Global Servs., Inc.*, No. H-15-1299, 2016 WL 4564472 (S.D. Tex. Sept. 1, 2016).

This recent case involved dueling delay claims between a general contractor and its subcontractor. It also involved a consequential damages waiver that seemingly attempted to contractually redefine consequential damages, although the evidence apparently resulted in a narrow interpretation of the clause.

PEMEX owned an offshore platform in the Gulf of Mexico and hired Dresser-Rand to install two compression modules for the platform. *Kiewit Offshore Servs.*, 2016 WL 4564472, at *1. Dresser-Rand in turn accepted a bid from Kiewit to perform the engineering, design, and fabrication of the modules for the project, which was specifically referenced in Kiewit's proposal as "PEMEX Litoral Gas Compression Project." *Id.*, at **1, 8. The original contract price was $27,271,336. *Id.*, at *1. Kiewit delivered the modules but ultimately submitted eight invoices totaling $42,792,860. *Id.* After Dresser-Rand refused to pay the full amount invoiced, Kiewit sued seeking the full payment, along with $7 million in damages relating to "Dresser-Rand's failure to timely provide information necessary to complete the Modules[.]" *Id.*

Under the contract, Dresser-Rand "was required to provide key technical data to Kiewit", which Kiewit contended was "late, incomplete, and routinely revised." *Id.*, at *17. The parties also entered into the following consequential damages waiver:

> "**[Dresser-Rand] and [Kiewit] each hereby waive any and all Claims it may have against the other for consequential, special, punitive, or indirect damages, including but not limited to lost profits or business interruption, however same may be caused. The term "consequential damages" includes, but is not limited to, loss of production, loss of profits, loss of business, and loss of use. [Dresser-Rand's] sole and exclusive remedy under this Contract, at law, or otherwise in respect of delays shall be the payment of liquidated damages as described in Appendix "A," which by definition includes any consequential and/or indirect damages suffered by [Dresser-Rand, is affiliates, its client, contractors, and suppliers.]**"

Id., at *7. Dresser-Rand counterclaimed, arguing that Kiewit's delays had caused PEMEX to assess over $1.3 million in liquidated damages against Dresser-Rand. Both parties filed motions for summary judgment on the basis of the consequential damages waiver. *Id.*

Dresser-Rand's Pass-Through Liquidated Damages

Prior to addressing the waiver question, the court had already concluded that the liquidated damages that PEMEX assessed against Dresser-Rand were not sufficiently foreseeable to be recoverable as either direct or consequential damages. *Id.*, at *9. But the court nonetheless proceeded to engage in a direct versus consequential analysis, concluding that these damages were consequential (and therefore waived). *Id.* Although the court noted that it was "clear that, at all times, Kiewit was aware that the Modules were intended for PEMEX[,]" the court held that any liquidated damages assessed by PEMEX were damages stemming "from a third-party contract." *Id.*, at **8-9. The court relied primarily on the fact that the contract was silent as to any allocation of damages assessed against Dresser-Rand by PEMEX. *Id.*, at *10. The court found that the damages depended "entirely on a fact 'beyond the relationship between the parties.'" *Id.* (*quoting Powell Elec. Sys.*, 356 S.W.3d at 119).

Kiewit's Project Impact Damages Claim

Kiewit alleged that Dresser-Rand had failed to timely provide information required under the contract. *Id.*, at *16. Dresser-Rand argued that Kiewit "plainly [sought] damages for delay costs, loss of efficiency, and loss of productivity, which are consequential in nature." *Id.*, at *17. Kiewit countered that "many of the key assumptions underlying Kiewit's bid were proven to be unfounded due to Dresser-Rand's errors" and that its acceleration costs to finish the project were accordingly the "direct consequence of Dresser-Rand's . . . breaches of the Contract[.]" *Id.* Dresser-Rand, for its part, asserted that "delay damages" and "loss of productivity" were by their nature consequential damages. *Id.*

The court sided with Kiewit, reasoning that Dresser-Rand had failed to identify any "facts beyond the relationship between the parties on which Kiewit's Project Impact Damages claim relie[d]." *Id.* (internal quotations omitted). The court emphasized that Kiewit's claim related solely to Dresser-Rand's purported failure to comply with the its contractual obligations, which in turn interfered with Kiewit's ability to perform. *Id.* Finally, the court rejected Dresser-Rand's argument that the consequential damages waiver precluded all "loss of productivity" simply because it referenced "loss of production," apparently on the basis that "loss of production" in

the contract referred to loss of *oil* production, rather than productivity loss. *Id.*, at *18.

The case raises a host of issues, including just what is needed in a contract to demonstrate direct damages. Consider an owner who hires a contractor to build an apartment complex, under a contract that says "CONTRACT FOR APARTMENT COMPLEX WITH UNITS THAT WILL BE LEASED." Assume also that there is no serious dispute that the contractor is aware that the owner intended to lease the units, that the contract waives consequential damages, but is otherwise silent as to remedies for the contractor's rents lost due to the contractor's breach. Now assume that latent defects or a delayed opening caused by construction defects results in lost rents for the owner. Are they recoverable? Under *Kiewit*, that is uncertain, because the court denied damages even after acknowledging that it was "clear" that Kiewit understood the contract to be for the ultimate benefit of PEMEX. The specific reference to the end user of the project, as well as the alleged breaching party's subjective knowledge of that end user, was insufficient.

In contrast, Dresser-Rand's claims were dispatched largely on the basis that they involved third-party contracts. Suppose that part of Kiewit's damages involved extended equipment rentals with a third-party that it incurred because of Dresser-Rand's alleged failure to timely provide information. Even though the damage would still arise out of Dresser-Rand's contractual obligations, would the fact that it involved third-party contracts be enough to render such damages consequential? Without a clear answer, careful practitioners should anticipate potential categories of damages, and consider specifically including them in contracts (or consider removing consequential damages waivers entirely).

vii. *Jay Jala, LLC v. DDG Constr., Inc.*, No. 15-3948, 2016 WL 6442074 (E.D. Penn. Nov. 1, 2016).

The last case involved a typical AIA mutual consequential damages waiver, and a federal court's evaluation of it against numerous categories of claims. Although not a Texas decision, it is a very good example of how a typical court deals with a routine construction dispute using the most common industry form contract.

Jay Jala hired DDG Construction to act as the general contractor on a new Motel 6. *Jay Jala*, 2016 WL 6442074, at *1. DDG Construction's original contract price was $2,404,171, with an August 2014 completion date, later extended by agreement to October 2014. *Id.* The project was not completed by January 2015, at which point Jay Jala terminated DDG Construction, and completed the project itself by May 2015. *Id.*

The parties had entered into the following consequential damages waiver, directly from the AIA form:

> "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."

Id. (emphasis added). The contract also contained a time is of the essence clause specifically referencing the completion date, and entitled Jay Jala to recover "costs the Owner incurs that are payable to a separate contractor because of the Contractor's delays, improperly timed activities, or defective construction." *Id.* DDG Construction stipulated its own liability, but argued that the following categories of Jay Jala's damages were barred by the consequential damages waiver: (1) loss of income; (2) insurance; (3) advertising expenses; (4) furniture fixtures and equipment and interest paid; (5) bank interest; and (6) utilities paid from January 23, 2015 (DDG's termination) until May 15, 2015 (project completion). *Id.*

Loss of income

Jay Jala withdrew "its claim for lost profits or loss of income" prior to the court's ruling. *Id.*, at *3. The court declined to comment on whether it was direct or consequential, but editorialized that "[n]o doubt" Jay Jala withdrew these claims because they were "quite clearly covered by the waiver."

Project Completion Fee

There was a dispute between the parties as to what was sought through this element. DDG Construction had elicited testimony that this damage included costs incurred because one of Jay Jala's managers had lost money by "spending all [his] time for this project." *Id.* The court stated that if that were the case, the damage "would indeed be precluded by the consequential damages waiver." *Id.* But there

was also evidence that the damages sought by Jay Jala related to overhead costs that it had to pay to complete the project generally. *Id.* The court held that if this latter was the element proven at trial, it was a recoverable direct damage. *Id.*, at *4. The court pointed to a provision in the contract entitling DDG to a "Company Overhead" fee, and because Jay Jala took over the role of general contractor, it would have had overhead fees, too. *Id.*, at *3. Sua sponte the court addressed whether the owner's waiver for "loss of management or employee productivity or of the services of such persons" was independently waived, but held that the "project completion fee" was not implicated by the provision because it is just a substitute for the *general contractor's* fee, not the owner's use of separate personnel during the project. *Id.* Put differently, the replacement overhead cost constituted the "direct costs of replacing the performance [DDG] failed to render." *Id.*

Insurance

Jay Jala sought its insurance costs (liability, workers' compensation, and other insurance associated with running a hotel) made after the agreed completion date but before the Motel 6 was opened, apparently because Jay Jala decided to carry the coverage prior to the motel's actual open. *Id.*, at **4-5 Although Jay Jala pointed to contract language requiring the contractor to provide insurance during the life of the project, the court held that the type of insurance sought by Jay Jala (hotel operation insurance) had nothing to do with the, for e.g., builder's risk policy contemplated by the contract. *Id.*, at *4. Despite acknowledging that Jay Jala's "unnecessary payments were a consequence of the delayed opening, which was [DDG's] fault[,]" the court held that this was a consequential (and therefore waived) damage because it related to "a separate business arrangement that" Jay Jala had made, rather than "something [Jay Jala] had to pay in an effort to replace the performance [DDG] failed to provide." *Id.*, at *5.

Advertising Expenses

Jay Jala had rented a billboard in October 2014, saying "Motel 6 coming soon." *Id.* Because of the delay caused by DDG, Jay Jala had to keep the billboard up longer than expected, and sought this extra rental cost from DDG. *Id.* The court held that this was consequential because there was simply no provision in the contract addressing DDG's responsibility for the billboard cost. *Id.* The court determined that although the delay contributed to the wasteful billboard costs, "they were not part of the value of [DDG's] performance." *Id.*

Furniture, Fixtures, and Equipment

This was a factually nuanced claim. The contract did expressly make DDG responsible for storage equipment for furniture, fixtures, and equipment between the date of delivery and eventual installation into the Motel 6. *Id.* The damages Jay Jala sought were for the cost of *leasing* the furniture, fixtures, and equipment during the extra period of delay. *Id.* In a technical strict reading of the contract, the court held that contractually recognized "storage container" costs were not the same thing as contractually unrecognized "equipment rental" costs, and held that this damage element was therefore consequential. *Id.* It was of no moment that Jay Jala had to pay the cost owing to DDG's delay, since this cost was not technically something DDG was responsible for under the contract. *Id.* Sua sponte, the court also opined that the provision in the consequential damage waiver concerning "damages incurred by the Owner for rental expenses" might be an alternative ground to deny that recovery. *Id.*, at *5 n.4.

Bank Interest

Jay Jala sought interest paid on its construction loan owing to the delayed construction. *Id.* DDG responded that the consequential damages waiver specifically identifies "financing" as an excluded damage. *Id.*, at *6. Interestingly, the court sided with Jay Jala, arguing that it had to extend financing "in an effort to get what it bargained for[.]" *Id.* The court considered extra financing an "integral cost of completing [DDG's] performance" defined as "construction of the building." *Id.* Although the court did not point to any specific contractual provision requiring the payment of financing, it did note that the contract entitled Jay Jala to recover for delays, and likened the added interest to "any other necessary construction input." *Id.*

Utilities

This element concerned extra utility costs that Jay Jala paid from termination to completion. *Id.*, at *7. The court held this was a direct damage, referencing provisions from the contract requiring DDG to pay utility bills during construction (i.e. until completion). *Id.* The court held that because these costs were expressly contemplated in the contract, they were recoverable as direct damages. *Id.*

Compare the court's treatment of the waiver from that in *Tennessee Gas Pipeline*. In the latter, the court held that the enumerated provisions merely identified a subset of waived consequential damages. By contrast, the federal court

in *Jay Jala* appeared willing to treat the enumerated categories as standalone waived damages, regardless of whether they were direct or consequential.

The decision did invoke some legal analysis that appears specific to Pennsylvania law, but the reliance on contractual language, and looking to what the contract actually required, is similar to analyses performed by the Texas courts in the case studies. The shorthand, which could be persuasive to Texas courts, is: direct damages are those incurred to replace the breaching parties' services, whereas consequential damages are all other costs incurred due to the breaching parties' failure. That analysis is not identical to, but is certainly consistent with, the holdings in, for *e.g.*, *Powell Elec. Sys.* As always, the most critical factor that the court considered was what the contract actually said. At the risk of belaboring the point, a party who does not include reference to a particular breach or damage runs the risk of a court later declaring the damage consequential.

The court treated the added interest damage as being "naturally integrated" into the cost of construction. But it also seemed like a potential candidate for the sort of damages incurred under third-party or collateral contracts. *See, e.g.*, *Tennessee Gas Pipeline*, 2008 WL 3876141, at *9. I could not find any Texas cases directly addressing whether additional costs associated with construction financing were direct or consequential, but the Virginia Supreme Court's much cited opinion in *Roanoke Hosp. Assoc. v. Doyle & Russell, Inc.*, 214 S.E.2d 155 (Va. 1975) did address the issue. There the court was faced with three type of interest claims: (1) added interest costs during the construction period arising from having a longer term of borrowing due to the contractor's delay; (2) added interest costs during the construction period attributable to a higher interest rate demanded by the lender due to an extended term; and (3) added interest costs for the permanent loan due to changes in the market rate during delay. *Id.* at 160. The court agreed that added interest owing to higher interest rates (i.e. (2) and (3)) were consequential, but held that "extended financing costs" were a direct damage because:

> "Customarily, construction contracts, particularly large contracts, require third-party financing. Ordinarily, delay in completion requires an extension of the term of construction financing. The interest costs incurred and the interest revenue lost during such an extended term are predictable results of the delay and are, therefore, compensable direct damages."

Id. at 160-162. The court in *Tennessee Gas Pipeline* distinguished factually but did not disapprove of this specific holding. (Recall that the interest damages sought in

Tennessee Gas Pipeline related to lost interest the owner *might* have earned, rather than out-of-pocket extended financing caused by some delay.)

If anything should be apparent at this point, it is that it is very difficult to predict with great certainty how any given court will treat construction damages. The cases are factually intensive, especially as to contract language. If you advise your client to recommend or accept waiving consequential damages, remember that not even you may know precisely what is being waived.

c. Foreseeability

Your client has not waived consequential damages, but wants to recover them or defend against their recovery. Whether consequential damages are recoverable depends predominantly on whether they are foreseeable, which requires a legal analysis of equal complexity to the direct versus consequential damages discussed above. Predictably, the results are unpredictable. This section will address how courts evaluate whether consequential damages are sufficiently foreseeable to be recoverable, whether Texas requires objective (reasonable person) or subjective (actual) foreseeability, and finally briefly address what a party needs to do procedurally to recover consequential damages.

i. Texas standard on foreseeability

Under Texas law, foreseeability derives directly from the *Hadley* formulation. In *Basic Capital Mgmt.*, the Texas Supreme Court called foreseeability "a fundamental prerequisite to the recovery of consequential damages for breach of contract." 348 S.W.3d at 901. The Court cited approvingly the *Hadley* formulation, as well the *Restatement (Second) of Contracts*, which states:

> (1) Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.
>
> (2) Loss may be foreseeable as a probable result of a breach because it follows from the breach
>
> > (a) in the ordinary course of events, or
> >
> > (b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach has reason to know.

> (3) A court may limit damages for foreseeable loss by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation.

RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981).

Although *Basic Capital Mgmt.* was not a construction case, it does provide a helpful application of this "fundamental" prerequisite. Basic managed publicly traded real estate investment trusts and Dynex provided funding for real estate investors, including entities like Basic and its subsidiaries. *Basic Capital Mgmt.*, 348 S.W.3d at 896. Through a complicated array of contracts, Dynex agreed to loan $37 million to Basic's subsidiaries in exchange for Basic identifying other entities to borrow an additional $160 million from Dynex. *Id.* at 897. Dynex did in fact loan some of the money to Basic's subsidiaries or related entities, but market interest rates rose, making the original terms that Dynex had agreed to unfavorable to Dynex. *Id.* Dynex refused the remainder of its remaining loan commitments and Basic (and its subsidiaries) sued, claiming that they lost qualification for financing that they otherwise would have had, or only found financing at higher rates than expected. *Id.* They claimed damages for increased interest paid above what would have been charged by Dynex, and lost profits from investments that never happened because Dynex withdrew its financing. *Id.* The jury held that Dynex had breached its loan agreement, resulting in (1) $256,233.25 in lost profits for Basic; (2) $25,367,090 in lost profits for Basic's subsidiaries; and (3) $2,183,287 in increased costs for obtaining alternate financing for Basic's subsidiaries. *Id.* at 898.

Dynex moved for directed verdict on the basis that the $256,233.25 in lost profits were consequential damages but not reasonably foreseeable. The trial court granted a take nothing judgment for Dynex. *Id.* (The court granted the motion on Basic and its subsidiaries non-lost profit damages for reasons that have nothing to do with foreseeability. *Id.*) The Dallas Court of Appeals agreed with respect to lost profits, reasoning that there was no evidence that Dynex knew at the time it entered into the loan commitment about the *specific* investments that would be proposed, or that alternative financing would otherwise not be available in the event of Dynex's default. *Id.*

The Texas Supreme Court held that a lender should not have to know of the *specific* venture that a borrower intends to engage in with the money in order for damages resulting from default to be foreseeable. *Basic Capital Management, Inc.*,

348 S.W.3d at 902. Instead, the court held that a lender must only have known "the nature of the borrower's intended use of the loan proceeds" without having to know "the details of the intended venture." *Id.* at 903. The Court went on to note that Dynex was certainly aware of the general nature of how Basic and its subsidiaries intended to spend the borrowed funds, because "it would be surprising if Dynex had agreed to lend Basic [or its subsidiaries] $160 million without such knowledge." *Id.*

There are not that many Texas cases dealing with the contours of foreseeability, particularly in the context of construction. As previously noted, the court in *Balfour Beatty Rail* spent some time on foreseeability, but that was as part of its analysis of the direct vs. consequential issue. The court in *Kiewit Offshore Servs.* also found that Dresser-Rand's pass-through liquidated damages were not recoverable because they were unforeseeable, but its analysis depended almost entirely on *Longview Constr.*

Before diving into the facts of *Longview Constr.*, the case is relatively old (1975), and does not engage in an express consequential damages analysis; neither "consequential" nor "Hadley" are mentioned anywhere in the opinion. But it does have some familiar foreseeability elements. *See, e.g.*, *Longview Constr.*, 523 S.W.2d at 777 (stating "general rule that losses resulting from collateral contracts may not be regarded as arising out of breach of the contract upon which the action is founded").

The facts of the case are relatively straight-forward. Stephen F. Austin University hired Loggins to act as the general contractor to construct its stadium. *Id.* at 774. Loggins in turn hired Longview to perform site work and excavation. *Id.* Although Longview insisted that it had performed its work in accordance with the plans, Loggins disagreed. *Id.* at 774-75. Longview refused to correct the work, and Loggins hired a separate contractor to complete Longview's scope. *Id.* at 775. Due to delays in completing the site work, the University assessed liquidated damages against Loggins ($250 per day), who in turn sought to recover same from Longview. *Id.*

The jury found that Longview had breached, but also that Loggins had failed to prove that Longview *actually knew* that Loggins would be responsible for the liquidated damages for delay. *Id.* Interestingly, the jury also found that Longview "reasonably should have known that Loggins" would be responsible for the liquidated damages. *Id.* Based on the jury finding, the trial court awarded Loggins the pass-through liquidated damages against Longview, in the amount of $6,250.00. *Id.* at 777.

The Tyler Court of Appeals reversed as to the $6,250.00. *Id.* First, the court noted that there was nothing in the subcontract indicating that Loggins' prime agreement was incorporated into the subcontract. *Id.* Although Loggins' personnel had testified that they told Longview's President about the liquidated damages, Longview's witnesses denied the conversation, and the jury credited Longview's witnesses. *Id.* Citing cases from other jurisdictions, the court stated that "parties are not presumed to know the conditions of each other's affairs nor to take into account the provisions of a contract with a third party that is not known or communicated." *Id.* at 777-78. Because the jury determined that Longview did not have *actual notice* of the liquidated damages provision in the prime, the appellate court held that the $6,250.00 judgment must be reversed. *Id.* at 778.

The implications for upstream parties who fail to incorporate upstream contracts against their downstream subcontractors should be apparent. The case did not involve a consequential damages waiver at all; it simply stands for the proposition that Texas will not permit pass-through liquidated damages unless same are specifically referenced in the parties' subcontract. The case also dovetails into an unresolved issue under Texas law, namely whether foreseeability is judged by an objective or a subjective standard.

ii. Objective vs. subjective

Foreseeability can either be based on a subjective, actual knowledge standard, or an objective, reasonably foreseeable standard. Some courts have adopted an objective standard. *See Merix Pharm. Corp. v. Clinical Supplies Mgmt., Inc.*, 59 F.Supp.3d 865, 882 (N.D. Ill. 2014) (holding that "the standard for consequential damages in Illinois requires an objective analysis of whether the damages were reasonably foreseeable to the parties, not an inquiry regarding whether the parties expressly contemplated the particular damages when they signed the contract in question"). Others seem to rely on a subjective test. *See Porous Media Corp. v. Midland Brake*, 220 F.3d 954, 961-62 (8th Cir. 2000) (disallowing consequential damages because "the parties did not contemplates allowing . . . damages for post-contractual lost profits"). Still others use both. *See Lewis Jorge Constr. Mgmt., Inc. v. Pomona Unified Sch. Dist.*, 102 P.3d 257 (Cal. 2004) (describing special damages as recoverable if circumstances "were actually communicated to or known by the breaching party (a subjective test) or were matters of which the breaching party should have been aware at the time of contracting (an objective test)").

The confusion is hardly surprising, because *Hadley* itself mixed both objective and subjective elements. It described objective standards like "reasonably be supposed to have been in the contemplation of both parties" and "would reasonably contemplate[.]" *Hadley*, 9 Exch. 341. But it also included a subjective element. *Id.* (holding that damages arising from contract's "special circumstances" would be recoverable if they were "known and communicated," but not recoverable if they were "wholly unknown to the party breaking the contract").

So what's the law in Texas? I don't know, and could not find a Texas Supreme Court decision landing squarely on either side. The Texas UCC defines a *buyer's* incidental and consequential damages in objective terms:

> "Consequential damages resulting from the seller's breach include
>
> > (1) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting **had reason to know and which could not reasonably** be prevented by cover or otherwise[.]"

Tex. Bus. & Com. Code § 2.715(b) (emphasis added). The *Restatement (Second) of Contracts*, cited approvingly by the Texas Supreme Court in *Basic Capital Mgmt.*, contains objective tests. *See* RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981) (prohibiting recovery that party "did not have reason to foresee" but permitting recovery of damages resulting from special circumstances that the breaching party "had reason to know"). The Supreme Court in *Basic Capital Mgmt.* flirted with both as well, declaring the legal rule that "consequential damages resulting from breach of a loan commitment" are permissible where the "lender *must have known*", but relying on evidence that "it would be surprising" if a lender handed money over without actual knowledge. *Basic Capital Mgmt.*, 348 S.W.3d at 903 (emphasis added).

Recall that the court in *Balfour Beatty Rail* relied on a subjective test to determine that trackage fees were direct damages. *Balfour Beatty Rail*, 2012 WL 3100833, at *19 ("there is no evidence that BBRI was *actually aware* of the June 2007 newsletter…. Nor is there evidence that BBRI *was aware* that KCSR was using…") (emphasis added). Similarly, the court in *Kiewit Offshore Servs.* credited subjective *un*awareness as a basis for holding insufficient foreseeability. *Kiewit Offshore Servs.*, 2016 WL 4564472, at *8 (Dresser-Rand has identified no evidence in the record establishing that Kiewit *was aware* of the liquidated damages clause . . . . Accordingly, Dresser-Rand failed to show that Dresser-Rand's liquidated damages obligation to PEMEX was foreseeable to Kiewit.") (Emphasis added.).

The Tyler Court of Appeals in *Longview Constr.* specifically adopted a subjective only standard. Remember that the jury found that Longview (1) did not have *actual knowledge* of the upstream liquidated damages, but (2) "reasonably should have known that Loggins would be liable" for them. *Longview Constr.*, 523 S.W.2d at 775. The court rejected the "should have known" finding because it "presume[d] a lack of knowledge and therefore forms no basis for an award of special damages." *Id.* at 778.

So, what should lawyers do? Focus on both. If you are seeking (or resisting) consequential damages, paramount in your mind should be gathering subjective and objective bases for evidence. If you are deposing a general contractor on an apartment complex, ask if the contractor understood that the owner intended to rent the project. Ask your client at the front of the representation what it is he or she expected to get out of the contract. Pre-project e-mails should provide some basis for understanding what the parties intended. Recommending during contract negotiations that your client exchange its pro forma with the builder or designer will go a long way towards demonstrating the parties' expectations.

Except for *Longview Constr.*, there are several bases in Texas law for an objective standard, in particular *Basic Capital Mgmt.* For objective standards, consider having your experts (including your client representatives, to the extent they are designated as non-retained experts) opine about industry expectations. Industry standards matter. Recall that in the *Roanoke Hospital Ass'n* decision, the court credited industry *customs*. *Roanoke Hosp. Ass'n*, 214 S.E.2d at 802 ("Customarily, construction contracts, particularly large contracts, require third-party financing."). In *Denny Constr., Inc. v. City & County of Denver*, 199 P.3d 742 (Colo. 2009), the Colorado Supreme Court held that lost profits owing to impaired bonding capacity were not "speculative as a matter of law in all cases" because it was "clearly understood in the construction industry that a contractor's . . . bonding capacity can be severely impacted by perceived performance problems or litigation on any contract." *Denny Constr.,* 199 P.3d at 749 (*quoting* 6 Philip J. Bruner & Patrick J. O'Connor, Jr., *Bruner & O'Connor on Construction Law* at 291, (2002)).

iii. Procedure

Texas Rule of Civil Procedure 56, which appears unchanged since it was adopted in 1941, states: "When items of special damage are claimed, they shall be specifically stated." Tex. R. Civ. Proc. 56. The purpose of requiring special damages to be specifically pled is to provide notice to the defendant so that he can order his

defense accordingly. *See* Jeffrey R. Cagle, et al., *The Classification of General and Special Damages for Pleading Purposes in Texas*, 51 Baylor L. Rev. 629, 637 (1999).

The Austin Court of Appeals in *Green v. Allied Interests, Inc.*, 963 S.W.2d 205, 208 (Tex. App.—Austin 1998, pet. denied) described "consequential damages" as a subset of special damages. The statement was dicta, as the case concerned the pleading requirements for general benefit-of-the-bargain damages, but prudent practitioners will want to specifically plead consequential damages, if they have any suspicion that their clients are seeking an element reasonably categorized as consequential.

The federal rules contain a similar provision at Fed. R. Civ. Proc. 9(g): "SPECIAL DAMAGES. If an item of special damage is claimed, it must be specifically stated." The failure to plead special damages may render evidence of them inadmissible. *Precision Tune Auto Care, Inc. v. Radcliffe*, 804 So.2d 1287, 1292 (Fla. 4th D.C.A. 2002).[11] Since federal pleading standards are more stringent than Texas, be mindful of the heightened need to specifically plead for consequential damages.

III. Waiving Consequential Damages

Now that you know that nobody really knows what consequential damages are, let's discuss waiving them.

At the outset, it's important to keep in mind why we are discussing this in the first place. Consequential damages were seen by the construction industry as an appropriate response to arrest a roughly 24:1 judgment:fee arbitration award from the New Jersey case *Perini Corp*. I mention that because if your client has in mind a "fairer" judgment:fee ratio, and wants to limit his damages to that amount, consequential damages waivers are both inefficient and insufficient mechanisms for that limitation.

First, they're inefficient because there are much more direct and predictable ways to limit your client's liability. If your client thinks that its total appropriate risk is X times its fee, then you should recommend a limitation of liability clause capping your client's liability at its fee times X. That is a much more direct approach to a pretty straight-forward and identifiable problem. It will also save your client the legal fees associated with having to pay you to argue with another

[11] *See also* Dannecker, Jason W. Hill, John E. Kofron, and Dale B. Rycraft, *Recovering and Avoiding Consequential Damages in the Current Economic Climate*, CONSTRUCTION LAWYER at 29, Volume 30, Number 4, Fall 2010.

lawyer about whether profits lost on a collateral contract that is vaguely referenced in the contract is covered by the consequential damages waiver. Or not.

Second, they're insufficient because they do not guarantee an actual cap on liability. It may well be that your client's direct damages significantly exceed its consequential damages. The parties in *Powell Elec. Sys.* probably spent a non-trivial amount of money arguing over what turned out to be $747,770.57 in direct damages against $178,815.41 in consequential. The direct damages in *Balfour Beatty Rail* were roughly twice as large as the consequential damages.

But assuming you have committed to recommending that your client waive, or accept the waiver of, consequential damages, there really isn't much to it. The difficulties associated with consequential damages waivers arise not from their drafting, but through their enforcement. Drafting them is simple, and there are at least seven examples above of actually enforced consequential damages waivers.

One easy mistake to avoid is the *Tennessee Gas Pipeline* enumeration problem. In that case, the court treated enumerated examples of consequential damages as a limitation on the clause, holding that waiving consequential damages, including A, B, and C, meant that your client did *not* waive *direct* damages for A, B, and C. If you have taken the time to thoughtfully advise your client on specific categories of damages that they do not want to accept responsibility for, such as lost profits, rents, etc., the AIA waiver (referenced above) does a decent job. But consider revising it to make the enumeration issue slightly more explicit:

> Contractor and Owner waive all claims against each other for consequential, incidental, or special damages arising out of or relating to this Contract. The parties also waive the following damages, **whether they are consequential, direct, or otherwise**:
>
> .1 damages incurred by the Owner for [specific list of waived damages];
>
> .2 damages incurred by the Contractor for [specific list of waived damages].[12]

Bear in mind that even if the parties expressly enumerated a waived damage category, if either party is specifically entitled to a similar or even arguably similar

[12] Allison Snyder has a good example of a modification to the standard AIA language effecting this same change at page 27, here: http://www.porterhedges.com/portalresource/lookup/wosid/cp-base-5-2302/media.name=/What%20do%20you%20mean.pdf (last accessed by author on January 25, 2017).

damage elsewhere, you may have just created an ambiguity in the contract. And the court will probably resolve it in favor of the specific contractual entitlement over the broad waiver anyways. *See, e.g.*, *El Paso Mktg.*, 383 S.W.3d at 145. To avoid non-contractual claims that attempt to bypass the waiver, consider stipulating that it applies to "claims that arise in tort, in equity, or by statute." *See* Carson Fisk, *Contractual Limitations of Liability: Enforcement and Practical Tips*, in your program materials.

Perhaps the primary benefit of talking about consequential damages (or their waiver) with your client is that it will necessarily invite a conversation about what it is he or she expects to risk from the project. Never miss an opportunity to directly ask your client what it expects in the event the other side breaches the contract. Apartment owners, for example, will understandably be surprised to find out that their "collateral" contracts with tenants are waived consequential damages, when their only interest in constructing an apartment complex in the first place was to collect rents from tenants. Some contractors will understandably be surprised to find out that *profits*—the very reason for their existence—are apparently routinely included in consequential damages waivers. (*See* Sections II.b.ii., II.b.iv., and IIb.vi., *supra*.)

IV. Conclusion

In close cases involving disputed direct versus consequential damages, there is going to be something in the case law for everyone. It would be virtually impossible to distill over one-hundred years of consequential damages analysis into any concise conclusion. If you take nothing else from this paper, remember that "it's complicated" is a perfectly acceptable response to questions about consequential damages.

One last point. Lawyers do not have magic powers that allow them to reduce risks on construction projects. Workers will get injured, project managers will quit or move mid-project, subcontractors will go bankrupt, clay soils will expand, and 100-year floods will come. All we as lawyers can do is shift risk among the project participants. But the economic reality is that risk shifted to one party will inevitably return to the other in the form of lower (or higher) fees, less demand for work, etc. A client constitutionally opposed to accepting any hypothetical risks will instead reap non-hypothetical costs in the form of higher construction and design fees and less competition for its project. Owners pay CGL and E&O premiums in the same way that renters pay property taxes. Risk never goes away; it simply gets charged to someone else.

Except: The one area where lawyers can add value to the construction industry is by drafting clear contracts that accurately reflect our clients' intentions, thereby reducing the transaction costs associated with fighting over contractual language later. Consequential damage waivers are a useful shorthand way of *shifting* large categories of risk, but they probably increase transaction costs collectively because their legal meaning is uncertain (and therefore subject to expensive dispute resolution). In this way, non-specific consequential damages waivers probably benefit construction lawyers more than they benefit the construction industry.