



## **Harmonie's Construction Tool Box: Construction Laws, Cases, Notes and Alerts**

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This Edition of the Tool Box presents two papers authored by Harmonie Group Construction Lawyers that were presented this year at Harmonie Regional Conferences in Chicago and Denver.

In the first paper, Jim Thomson of Harmonie's Idaho firm Powers Farley, P.C. discusses the important and increasingly litigated issue of waivers of consequential damages in construction contracts. This presentation is timely and useful for contract drafters, claims personnel, and risk managers in the construction industry.

The second paper is authored by Pfenne Cantrell of Kightlinger & Gray, LLP in Indianapolis, and outlines key issues and points to consider in analyzing and defending construction defect claims, another important topic and subject of much current litigation.

These papers are illustrative of the cases and issues Harmonie lawyers engage in for clients on a daily basis.

- - The Editor

# Waiver of Consequential Damages

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## A. Introduction

When one party breaches a construction contract, the primary form of relief available is monetary damages. There are generally two types of damages available: (1) direct or general damages; and (2) indirect or consequential damages.

It is not unusual in the case of most commercial construction projects in the United States to see the parties utilizing standard American Institute of Architects (“AIA”) contract forms. One of the most often used forms is AIA Document A101 – Standard Form of Agreement Between Owner and Contractor. A commonly utilized component of many owner-contractor contracts is AIA Document A201 – General Conditions of the Contract for Construction. The AIA Standard Form of Agreement Between Owner and Contractor (A101) incorporates by reference the General Conditions AIA Document A201. AIA Document A201 establishes most of the general terms between the Architect, the Owner, the Contractor, and in many cases, the subcontractors. Among the terms set forth in AIA Document A201 is a mutual waiver of consequential damages, pursuant to which the contractor and owner waive claims against each other for consequential damages arising out of or relating to the contract.

## B. Brief History of the American Institute of Architects (AIA) Standard Contract Forms

The history of AIA Contract Documents dates to 1888 when the AIA first published the Uniform Contract for use between an owner and a contractor. In 1911, the AIA published its first standardized general conditions for construction. The 2007 edition of AIA Document A201 was the fifteenth edition of the general conditions. In 2017, the AIA released an updated set of core Contract Documents, including an updated Document A201.

## C. Foundation of the AIA Document A201’s Current Waiver of Consequential Damages Provision

A 1992 decision by the New Jersey Supreme Court, *Perini Corporation v. Greate Bay Hotel and Casino, Inc.*, 610 A.2d 364 (N.J. 1992), is often cited as a foundation for the current AIA Document A201 waiver of consequential damages provision. In that case, Perini was the prime contractor building a Sands Casino in Atlantic City, New Jersey. The original guaranteed maximum price under the contract was \$16,800,000, later increased to \$24,000,000, but Perini’s fee was limited to \$600,000 plus reimbursement for actual expenses. At Perini’s direction, the project was substantially completed on time, with the exception of a non-functional, ornamental façade designed to attract passersby from the boardwalk. Greate Bay Hotel sued Perini for damages resulting from the delay with the façade, and an arbitrator awarded the owner consequential damages in the amount of \$14,500,000 for lost profits. The New Jersey Supreme Court affirmed the arbitrator’s award, finding the arbitrators had more than enough evidence to conclude that Perini was aware that its failure to complete the project in a timely fashion could lead to a significant loss of income. Perini did not have a waiver of consequential damages provision in its contract with Greate Bay Hotel and Casino, Inc. Not only did it lose all of its compensation for the project, but Perini also became responsible

for paying 24 times its planned gross revenue to the owner. The New Jersey Supreme Court commented in the opinion that it was troubled by the magnitude of the award, but also observed that projects of this magnitude are better left to the agreement reached by the parties in their contract, and found the arbitrators had not exceeded their powers in making the award.

In response to the inequitable result in the *Perini* case and similar results in other cases around the country, the American Institute of Architects, in October 1997, adopted substantial revisions to the general conditions in its owner-contractor agreement. One major revision was the addition of a mutual waiver of consequential damages provision. The American Institute of Architects included this provision at the urging of the Associated General Contractors of America to address the gross inequities resulting from expanding awards of consequential damages.

#### **D. What does the term “consequential damages” mean?**

When we address the subject of consequential damages, the focus is on achieving a balance between two well-established legal principles in response to a breach of contract: (1) the goal of providing compensation for the non-breaching party; and (2) the determination and enforcement of risk allocation that the parties agreed to.

The law regarding consequential damages can be traced back to the English case of *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (1854), in which the court adopted a rule that has been followed ever since: that consequential damages will only be available as compensation for a breach of contract if they were within the reasonable contemplation of both parties at the time they entered into the contract. The court described general or direct damages as those which would normally be considered to arise in the usual course of events without regard to any special circumstances of the non-breaching party. On the other hand, consequential damages were defined as secondary consequences of non-performance resulting from the special circumstances of the non-breaching party. In one form or another, most jurisdictions follow the *Hadley v. Baxendale* holding that recoverable losses under a breach of contract claim are limited to damages that are reasonably foreseeable to the breaching party. See, e.g., *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.*, 869 P.2d 454 (Cal. 1994) (“Contract damages are generally limited to those within the contemplation of the parties when the contract was entered into or at least reasonably foreseeable by them at that time; consequential damages beyond the expectations of the parties are not recoverable”).

A hallmark of the *Hadley v. Baxendale* decision is that greater importance is placed on the agreed allocation of risk between the parties than achieving full compensation for the non-breaching party. Parties to a contract are deemed to have expected normal and usual risks in the absence of specific contractual language to the contrary. Therefore, general or direct damages, which represent the normal and expected risks, are always awardable. Consequential damages, however, which represent additional risks due to the unusual circumstances of the non-breaching party, are only available if the non-breaching party can establish the parties were aware of the special circumstances at the time they entered into the contract and, therefore, intended to allocate to the breaching party those additional risks resulting from the non-breaching party’s unusual position. Another way of describing consequential damages is that they are losses directly attributable to and caused by a contract breach as a result of the special circumstances of the non-breaching party that would not have occurred in the ordinary case of a breach of contract not involving such special circumstances. As long as a contract clearly spells out what the parties intended, a court will generally enforce it as written unless the intentions are contrary to law or public policy.

## **E. Examples of Direct versus Consequential Damages**

Direct damages are those damages that arise from the type of breach that the non-breaching party complains of. An example would be the cost to retain a replacement contractor to complete a project when the initial contractor abandons the project. Another example might be where a contractor's work is defective or otherwise fails to meet the requirements of the contract and the owner must repair, replace, or re-perform the work to bring it into accordance with the terms of the contract.

What constitutes consequential damages varies from situation to situation. Whether damages are general or consequential is generally determined according to the facts of each case. A common example of consequential damage is when a business is unable to open a retail location on time, and claims damages for the profits it would have realized during the time between when it should have opened and when it actually did, and could even include a claim of long-term damage to its brand. Or in the case of the delayed completion an apartment building, potential tenants might be forced to find another place to live. The owner might not only suffer from the lost rental incomes but may also incur additional marketing costs to attract new tenants. Other examples include extended overhead, loss of use, loss of bonding capacity, extended equipment rental fees, increased material costs, and interest. The difficulty is that there is no clear-cut definition of consequential damages and the situations leading to this type of damage claim can be very broad. Thus, a consequential damage waiver can be extremely important because the direct damages resulting from a contract breach can be dwarfed by those associated with the consequential damages a creative attorney can come up with.

## **F. The AIA Waiver of Consequential Damages Provision**

The waiver of consequential damages included in the latest edition of the AIA's Form A201 General Conditions for construction contracts is meant to limit the parties' liability to one another to direct damages. Limiting or eliminating the availability of consequential damages reduces the monetary incentives to escalate a claim and eliminates some of the uncertainty as to what risks the parties are reasonably undertaking when they enter into a construction project together.

Approximately every 10 years, the AIA revises the A201 General Conditions. The last version of the AIA General Conditions was issued in 2007. The most recent version is the 2017 revision. The waiver of consequential damage provision in the 2017 version is not significantly different in substance from the prior 2007 addition.

AIA Document A201 – 2017, General Conditions of the Contract for Construction, at Section 15.1.7, provides as follows:

### **15.1.7. Waiver of Claims for Consequential Damages**

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

- .1 damages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business

and reputation, and for loss of management or employee productivity or of the services of such persons; and

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

This mutual waiver is applicable, without limitation, to all consequential damages due to either party's termination in accordance with Article 14. Nothing contained in this Section 15.1.7 shall be deemed to preclude assessment of liquidated damages, when applicable, in accordance with the requirements of the Contract Documents.

#### **G. Risks and Benefits Associated with Including a Waiver of Consequential Damages in a Contract**

There are risks associated with including the AIA Document A201 waiver in contracts. The standard waiver lists types of consequential damages that are eliminated by the waiver, but the wording (i.e., use of the word "includes") is not clear as to whether the types of damages identified are intended to be simply examples, or a complete list that leaves the possibility open for recovery of other types of consequential damages. Obviously, the vague waiver language requires the party asserting the waiver in certain situations to convince the court that the waiver extends beyond the situations specifically identified. Of course, the party resisting application of the waiver (i.e., seeking to recover consequential damages) would argue the examples identified are intended to be exclusive. This potentially introduces a good deal of uncertainty where the purpose for including the waiver in the first place was to reduce uncertainty.

In a recent Florida case, *Keystone Airpark Authority v. Pipeline Contractors, Inc.*, 266 So.3d 1219 (Fla. Ct. App., January 25, 2019), the court addressed whether damages sought by the owner from a contractor were consequential damages that were waived by the contract, or other types of damages that were not waived. The Airpark alleged that an engineering firm failed to properly supervise a contractor's work on an airplane hangar and taxiways. The Airpark alleged the contractor used substandard material for stabilization underneath the structures, which caused concrete hangar slabs and asphalt taxiways to prematurely deteriorate. The Airpark sought to recover from the engineering firm the cost to remove, repair, and replace the hangars, taxiways, and underlying subgrade. It sought the same relief from the contractor.

Relying on *Hadley v. Baxendale*, the Airpark argued that the cost of repair to the hangars and taxiways constituted general damages and not consequential damages because those damages were foreseeable. The engineering firm agreed it was foreseeable that the failure to supervise construction work could result in the need for repairs, but nevertheless argued these damages were consequential. The *Keystone* court affirmed summary judgment for the contractor based on the damages being consequential and barred by the contract. The court found the case to be analogous to others that have found the cost to repair or replace property damaged following deficient inspections or other services constituted consequential damages, but at the same time certified the question to the Florida

Supreme Court.

The *Keystone* court engaged in a discussion in its opinion of the different types of damage that leaves room for interpretation as to whether any particular damage is consequential or not. Nevertheless, a significant take away from the case is that a waiver of consequential damages tends to be better for the contractor and consultants as opposed to the owner, who is much more likely to have damages that can be classified as “consequential.”

An advantage of a waiver of consequential damages is that it provides a level of certainty that, in the event a party breaches a contract, the damages available to the non-breaching party are limited and would not include whatever categories of damages are defined in the contract as consequential damages. Part of the justification for waivers of consequential damages is to provide the parties an opportunity to quantify their risk. In addition, the waiver of consequential damages, which effectively limits the parties to being able to recover damages directly resulting from a contract breach, is viewed as a tool to reduce the incentive the parties may have to escalate their claims. The hope is that this would lead to settlement of claims as opposed to encouraging protracted litigation.

If, however, you happen to be the non-breaching party, you may be disadvantaged. While having a waiver of consequential damages may avoid unknown and unforeseeable liabilities in the event of a breach, you may, as the non-breaching party, end up not receiving all the damages you believe you are entitled to. It is also possible, depending on how broadly the provision is applied, that the inclusion of a waiver of consequential damages can result in a waiver of direct damages that may otherwise have been recoverable.

In most states sophisticated parties are permitted to contract, at arm’s length, for whatever provisions they agree to. Consequential damage waivers will typically be enforced just like any other commercial contract term. It is important to note that waivers of consequential damages may also be mutual or work only in favor of one party or the other, such as the owner or contractor. It is important to understand which type of provision you are dealing with when negotiating and administering a contract.

#### **H. Considerations in Determining Whether to Agree to a Waiver of Consequential Damages**

Both the owner and contractor should consider whether a waiver of consequential damages is necessary, or in a case where AIA Document A201 is used, whether a modification of Section 15.1.7 is necessary. If there are specific concerns as to potential costs to either party that may be incurred as a result of a breach, the parties may wish to specifically identify these issues or types of damages, rather than just waiving, or leaving open, the potential for consequential damages. As an example, the parties could agree to a liquidated damages amount for any delay in completing the project. It may also be better for the parties to define what damages are allowable, as well as what damages are not allowable, than to simply waive “consequential damages.”

Finally, other matters to consider may include what types of damages may be covered by insurance, as well as whether a consequential damages waiver survives a termination of the contract.

## Disputing Construction Defect Claims

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- I. Unique aspects of litigating in construction defect cases:
  - a. The requisite elements of the plaintiff's claim, and the available defenses to the claim will vary depending on the nature of the claim, and the relationship of the parties.
    - i. Depending on the nature of the claim, the claim may sound in tort, contract, or both.
  - b. Review of the complete contracts and knowing what defenses to look for is essential to determining the duties, defenses and possibility of shifting the risk of loss
  - c. Document production tends to be voluminous and expensive
  - d. Imperative to understand the flow of communication and documentation for the project
  - e. Often expert intensive on both liability and damages aspects
- II. Typical issues that arise at the inception of the case:
  - a. Identifying the nature of the claim, which will control what the plaintiff must prove to be successful and what defenses are available.
    - i. Typical allegations that arise:
      - 1. Design/Engineering defect
      - 2. Defective materials
      - 3. Defective Workmanship
      - 4. Failure to inspect/discover defect
      - 5. Scheduling/construction delay/cost over-runs
  - b. What was the relationship among the contractors?
    - i. Design-Bid-Build vs. Design-Build
      - 1. Who has the responsibility for the ultimate design?
      - 2. Delegation of design vs. delegation of responsibility for design
    - ii. General Contractor vs. Prime Contractor and Construction Manager
      - 1. Liability of general/prime contractor vs. construction manager for defective work

- a. General contractor/prime contractors will generally have a contractual responsibility for the quality of the work of their sub-contractors
  - b. Construction manager generally has no duty to guarantee the quality of the work-- have to show some failure to perform beyond the mere existence of the defect
- c. Risk Shifting--Whose Fault vs. Whose Responsibility?
  - i. Is there a duty to indemnify?
    - 1. You want to send the tenders out early in order to shift costs of defense
  - ii. Duty to Insure.
    - 1. Often better protection than indemnity rights, depending on the coverage.
      - a. Duty to obtain coverage naming other parties as insured
      - b. Duty to obtain coverage against the risk of loss for the benefit of both parties—may be an implied waiver of subrogation
      - c. Express waiver of subrogation
- d. Nature of the damage impacts to available theories of recovery and available defenses.
  - i. Personal Injury
    - 1. Generally tort theories of recovery
      - a. No privity requirement
      - b. No limitation of liability
  - ii. Damage to “other property”
    - 1. Likely to have tort liability
      - a. No privity requirement
      - b. No limitation of liability for third party claims
    - 2. Possible to have contractual liability
      - a. Third party beneficiary status
      - b. Where the plaintiff is a party to applicable contract, there could be a limitation of liability

- iii. Damage to “the work”
  - 1. Economic loss doctrine—no tort remedies/contract only
    - a. No strict liability theories for defective products/materials supplied
  - 2. Privity/third party beneficiary status required
    - a. Arises where damage to “the work” caused by a subcontractor.
  - 3. Limitation of liability
- e. The contract documents—the contract often consists of multiple documents that have to be reviewed
  - i. Often incorporated documents will themselves reincorporate other documents
    - 1. Resolving conflicts between incorporated documents
  - ii. Typical documents incorporated will be:
    - 1. Bid documents
    - 2. General terms and conditions
      - a. AIA contracts
      - b. Other standard forms
    - 3. Project manual
    - 4. Design documents
      - a. Design drawings will often include notes sections with specific details regarding what is required, and may incorporate by reference other standards and documents
    - 5. Industry standards
      - a. Structural steel AISC Manuals and Code of Standard Practice
      - b. Highway—MUTCD
      - c. ASTM/ANSI standards

### III. Discovery

- a. Typically voluminous; therefore requires a good strategy for handling from the inception of the case
  - i. E-discovery
    - 1. E-mails
      - a. .pst files
        - i. Provides the metadata
        - ii. You can see the attachments
    - 2. CAD drawings
    - 3. PDFs
    - 4. .jpegs/.mov files
    - 5. Scanned documents
      - a. Handwritten notes
      - b. Mark-ups.
  - ii. Document management software invaluable to manage
- b. Pre-contract documents
  - i. Bid documents
  - ii. Requests for proposals
  - iii. Meeting minutes
- c. Job files
  - i. Shop drawings
    - 1. Submittals
    - 2. Mark-ups
    - 3. Approvals
    - 4. Release for construction
  - ii. Inspection reports
  - iii. Daily reports
  - iv. E-mails

- v. Meeting minutes
  - vi. Photographs/videos
  - vii. Time sheets/cards
  - viii. Invoices/pay applications
  - ix. Request for Information/Responses
  - x. Change Order Requests/ Responses
  - xi. Pay applications/Approvals
- d. Repairs
- i. Design of repair
  - ii. Cost of materials

#### IV. Affirmative Defenses

- a. Statute of Limitations
- b. Statute of Repose
- c. Right to cure/right to repair/notice of defect
- d. Arbitration/pre-suit mediation?
- e. Limitation of liability/limited warranty
- f. Waiver of Subrogation
- g. No privity of contract
  - i. Third party beneficiary?

#### V. Experts

- a. Liability experts
- b. Damages experts