

WHAT ARE CONSEQUENTIAL DAMAGES?

By

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It is not uncommon for a business person to be offered a contract that contains a provision stating, in effect, that in the event a party breaches the contract, the damaged party will not be entitled to recover consequential damages. For example, written warranties made in connection with the sale of goods routinely provide that the seller will take certain actions with respect to any defective products, but that, in no event, shall the seller be liable for consequential damages. Some contract forms used in the construction industry, particularly those marketed by the American Institute of Architects (the AIA), provide that both parties -- the owner and architect in the Owner-Architect Agreement and the owner and contractor in the Owner-Contractor Agreement -- waive consequential damages for claims arising out of the agreement. What do these provisions mean? Under what circumstances would you want to include or delete such a provision when negotiating a contract?

When a party fails to perform part or all of the required duties under a contract, the other party -- the nonbreaching party -- can turn to the legal system for a remedy. One of the most common remedies available under the law to a nonbreaching party is the award of damages. In the context of contract law, the award of direct and consequential damages is intended to compensate the nonbreaching party for the injury suffered as a consequence of the breach. The goal of the law is to place the nonbreaching party in the financial position they would have occupied had the contract been fully performed.

Before compensating a party for an injury, the law requires that the injury must have been reasonably foreseeable to the other party. This is a significant limitation on damages. In our legal system, breaching a contract is not considered morally reprehensible. If people make a bad deal or contract, they are permitted to walk away from it, provided they are prepared to compensate the other party for the damages arising from the breach. Damages that could not have been reasonably foreseen by the breaching party at the time they entered the contract are not recoverable.

So called "direct damages" are those damages which courts have concluded over time naturally and necessarily flow from a breach of contract. They are often called "loss of bargain damages" and are considered so usual when contracts are breached, that they are conclusively presumed to have been foreseen or contemplated by the breaching party. For example, if a seller agrees to sell land or goods for a certain price and then refuses to go through with the sale, the buyer can always recover, as direct damages, the difference between the fair market value (fmv) of the subject property at the time of breach and the contract price, if the fmv exceeds the contract price. That difference is the "benefit of the bargain" the nonbreaching party reasonably expected to gain from the transaction.

Consequential damages differ from direct damages in that they are caused by special circumstances beyond the contract itself. For example, when a seller does not deliver goods, *knowing* that the buyer is planning to resell those goods immediately, the nonbreaching buyer may recover consequential damages consisting of the loss of profits from the planned resale. For the nonbreaching party to recover consequential damages, the breaching party

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must have known -- or had reason to know – when entering the contract that special circumstances would cause the nonbreaching party to suffer an additional loss. If the injury complained of is outside the usual and foreseeable course of events, the nonbreaching party must show specifically that the breaching party had reason to know the facts and foresee the injury at the time the parties entered into the contract.

Managing risk in any business starts with a clear understanding of the scope of consequential damages which the business might suffer or for which the business might become responsible in case of a breach of contract. A provision in a seller's warranty eliminating the seller's liability for consequential damages or a mutual or reciprocal waiver of all consequential damages between the parties could, depending on one's point of view, effectively counter a catastrophic claim or deny a party full compensation for its loss. That is why, at the inception of any transaction, whether it is a sale of goods or a construction project, each party should assess the financial risks and obligations being undertaken.

In a sales transaction, the seller's principal risk is that the buyer will not pay the purchase price of the goods. The buyer, on the other hand, may lose the lost profit on an expected resale or suffer loss of good will if it resells a defective product. Accordingly, a waiver of consequential damages in most instances only benefits the seller. That is why such a provision is included in so many limited warranties. In contracts between a client and a professional for the professional's services, one of the professional service provider's principal risks is that he or she will not be paid. The client, on the other hand, could suffer significant consequential damages in the event the professional does not perform, including lost income or profits resulting from delay. In such event, a waiver of consequential damages could leave the client without any remedy. However, for the professional service provider, a mutual waiver (such as those found in the AIA's standard contract forms) is a significant tool for limiting the professional service provider's risk on the project.

The takeaway point of this article is that clauses in contracts relating to consequential damages are not useless "boilerplate," but have real consequences to both parties and should be carefully considered. The parties could, in lieu of fighting over whether a waiver of consequential damages stays or goes, carefully list the major risks inherent to the project and make express provision for the types and amount of damages for which each might be liable.

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