

# Should your construction agreement include a waiver of consequential damages?



By Kenneth R. Crystal and  
Allen Major, Phillips Lytle LLP

**M**any form construction agreements include a mutual waiver where both the owner and contractor waive claims against each other for consequential damages. What are consequential damages? And should the owner, contractor and subcontractor agree to waive them? What are the implications of the waiver?

## WHAT ARE CONSEQUENTIAL DAMAGES?

Consequential damages (sometimes called special damages) in construction projects are indirect damages or losses incurred by either the owner or contractor arising from the other party's breach, as contrasted with direct damages, described below.

A contractor's claim for consequential damages might include a claim for loss of business opportunities. Suppose an owner delays a project by making design changes mid-construction or takes too much time to make key decisions. In those cases, a contractor might claim damages for keeping their

team on the project for a longer period than anticipated, thus preventing the team from deploying to a different project. In an extreme case, a contractor can face insolvency due to prolonged project delay.

Consequential damage claims made by an owner might include loss of business reputation or insolvency. Suppose an owner agrees to build stores at multiple locations for a national retailer. After construction is severely delayed at one location due to the contractor, the retailer seeks to back out of opening at all locations. The owner might seek consequential damages for losses associated with all locations. An owner might also face insolvency due to increased carrying costs associated with project delay.

## DIRECT DAMAGES

Another common type of damages incurred during construction projects that face problems are direct damages, which are losses or damages that are the natural and probable result of a breach of contract. Direct damages com-

monly sought by an owner from a contractor include the cost to correct faulty work or to complete unfinished work. When a contractor seeks direct damages from an owner, it might be for the contractor's additional costs or general condition expenses associated with project delay.

## THE OWNER'S INTEREST AND THE CONTRACTOR'S INTEREST

Broadly, owners typically do not want to waive the right to consequential damages, whereas contractors do. It's typically easier, for example, for an owner to prove loss of income due to contractor delay or negligence on a project than it is for the contractor to prove loss of business opportunities due to owner delay caused by indecision or design changes. Also, the magnitude of an owner's claim for consequential damages might be quite large (for example, lost income due to a contractor's failure to complete a large commercial development, which, in extreme cases, could exceed the value of the construction contract). In contrast, a contractor's claim for

consequential damages might be smaller (for example, the lost profit that the contractor could have earned on a different construction project).

An owner might also not want to agree to an unqualified waiver of consequential damages because of possible liability to third parties. Suppose that the neighboring property to a development suffers property damage or the neighbor's business is harmed as a result of the contractor's negligence. The neighbor might sue the owner for damages. The owner will want to seek indemnification from the contractor for the damages sought by the neighbor, some or all of which damages might be characterized as "consequential". The owner's broad waiver of consequential damages might preclude such a claim.

#### **MUTUALITY OF THE WAIVER**

Occasionally, the waiver of consequential damages might be one-sided. An owner might want the contractor to waive the contractor's right to consequential damages, while retaining the owner's right. In that case (or when the contractor seeks to have the owner waive their right to consequential damages), the other party should insist that if a waiver is included, it should be mutual.

#### **DRAFTING THE WAIVER**

The dividing line between direct damages and consequential damages is not always clear. Sometimes it is a judgment call (and in the case of litigation, the judge's call) whether damages claimed by a party flow directly from the

breach or are consequential. So, the parties may not know definitively in advance whether particular claims are in the nature of direct or consequential damages.

This can be an issue if the parties waive consequential damages in the construction agreement without describing what the term

means. Having waived consequential damages without knowing its precise application at the time of contract, a party seeking such damages due to an issue arising during construction may not know whether it has a valid claim.

To avoid this ambiguity, the parties should define what they mean

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by consequential damages. A well-drafted waiver provision will list the types of damages waived by each party. An owner might waive damages related to loss of use of the project, any rental expenses incurred, loss of income, profit or financing, or insolvency. A contractor might explicitly waive damages related to loss of business, loss of

financing, home office overhead and expenses, loss of profits not related to the project, loss of bonding capacity, loss of reputation, or insolvency.

In practice, a mutual waiver is usually included in the construction agreement, including the AIA Document A201®-2017 General Conditions of the Contract for

Construction. Its inclusion is usually in the contractor's interest, for the reasons discussed above, and the contractor will often insist on it. The owner, while understanding the contractor's position, might want to exclude certain claims from the general waiver of consequential damages. The owner might carve out claims by third parties (such as damage to a neighboring property, as discussed above), damages resulting from the contractor's gross negligence or willful misconduct, and losses covered by the contractor's insurance. With these carveouts, the owner could pursue these claims against the contractor, even if they might otherwise be classified as consequential damages.

#### **LIQUIDATED DAMAGES**

Another avenue providing the owner with recourse against the contractor, despite having waived the right to collect consequential damages, is to provide for liquidated damages. A liquidated damages provision in a construction agreement allows the owner to recover a predetermined amount of compensation if the contractor breaches certain contract terms, such as delays in completion. Liquidated damages might be stated as a fixed amount of money for each day of project delay. If the owner can determine in advance what its damages would be if a delay occurs (for example, extra interest owed to its lender), it can be made whole by syncing liquidated damages with its anticipated actual damages. This also protects the contractor by defining and lim-



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iting its exposure. A well-drafted waiver of consequential damages should carve out any agreed-upon liquidated damages.

### THE SUBCONTRACTOR'S INTEREST

A subcontractor should demand a waiver of consequential damages in its subcontractor agreement, particularly if the prime contract includes one. A subcontractor without a consequential damages waiver runs the risk that the owner or prime contractor sues it for losses disproportionate to the subcontractor's scope. A waiver protects the subcontractor from financial penalties incurred upstream by the prime contractor and delays caused by factors outside the subcontractor's control, such as design changes or unforeseen site conditions.

A waiver of consequential damages is a tool to allocate risk between parties. While the waiver of consequential damages is usually included in a construction agreement, the issue does not lend itself to a one-size-fits-all approach. Depending on the needs and risks faced by each of the parties for a particular project, the waiver might be broad or narrow. A blanket waiver typically favors the contractor, so the owner should seek to shift the risk by carving out exceptions from the waiver. In any event, the waiver should be well-defined. A competent construction lawyer could advise a party to a construction agreement as to the appropriate scope of the waiver of consequential damages based on the particular facts and circumstances of the project.

*Kenneth R. Crystal, Partner at Phillips Lytle, is a member of the firm's Real Estate Industry Team. He is a seasoned real estate and financial services lawyer with a national practice working with a wide range of clients in various industries. He can be reached at [kcrystal@phillipslytle.com](mailto:kcrystal@phillipslytle.com) or 212-508-0440.*

*Allen Major, Senior Associate at Phillips Lytle, is a member of the firm's Real Estate Industry Team, advising clients across New York State on a wide range of real estate matters. He can be reached at [amajor@phillipslytle.com](mailto:amajor@phillipslytle.com) or 212-508-0464. ♦*



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