

## No Consequential Damages Clauses as a Defense

By Christian Carrillo

More often, owners are looking to recover lost profits, delay costs, and diminution in value from design professionals. Consequential damages such as these do not follow immediately from a breach of contract; rather, they are the consequences of the breach. But to be recoverable, consequential damages must be contemplated by the parties at the time of contracting. By inserting a “no consequential damages” clause into the contract, a design professional may protect themselves by demonstrating that the parties contemplated the risks and have agreed to allocate the risks away from the design professional.

It is happening more often: a client sues a design professional for breach of contract and seeks not just damages for allegedly defective work but also damages for lost profits on a real estate transaction that the client claims did not occur because of delay caused by the design professional’s breach. Under the surface, of course, owners and developers are seeking to recover any value they can in an era of falling real estate prices. Now, design professionals have become targets for the recovery of the value of failed deals if there is any question about their performance.

The design professional may be able to make itself a less attractive target. If the service contract is carefully crafted, it should include a “no consequential damages” clause – in other words, a clause that shields the design professional from consequential damages if sued for breach of contract. With clients seeking to shift the decline in their property’s value to anyone they can, a “no-consequential damages” clause may insulate the design professional from expanded liability.

Determining exactly what types of damages are considered “consequential” is essential. California law establishes a somewhat convoluted framework to determine recoverable contract damages. First, statutory law defines the damages awarded for breach of contract. See CAL. CIV. CODE § 3300 (West 2010). Second, California common law, elaborating on the statutory definition, divides damages into direct and consequential categories. See Brandon & Tibbs v. George Kervorkian Accountancy Corp., 226 Cal. App. 3d 442 (1990). In this second phase, courts look at several factors to determine whether the damages sought are “consequential” and therefore subject to a contractual exclusion clause.

a. Legal Definition of “Damages”

California statutory law establishes damages for breach of contract as “the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result there from.” CAL. CIV. CODE § 3300. This statutory definition combines both elements of common law damages – direct (or general) and consequential (or special). The policy behind contract damages is that the injured party should receive as nearly as possible the benefits of the contract had it been performed. See Brandon & Tibbs, 226 Cal. App. 3d at 455; CAL. CIV. CODE § 3300; RESTATEMENT (SECOND) OF CONTRACTS § 344 (1981). California case law implements this policy by dividing contract damages into traditional categories of direct and consequential and elaborating on when each is recoverable. For the design professional to limit liability, understanding what qualifies as consequential damages is essential.

b. Direct vs. consequential.

The Court of Appeal has reflected at length on the differences between direct and consequential contract damages. Direct damages are confined to those which naturally arise from the breach, or as might have been reasonably foreseen at the time the contract was made as a probable result of a breach. See Brandon & Tibbs v. George Kervorkian Accountancy Corp., 226 Cal. App. 3d 442, 455-56 (1990). For example, an owner’s direct damages include the cost to the owner of a successor design professional who corrects the errors and omissions in the drawings of a breaching design professional.

Consequential damages are those that do not follow directly and immediately from the breach, but follow instead from some of the consequences of the breach. If special circumstances exist that cause an unusual injury to a party beyond the direct acts of the breaching party, those damages are considered consequential. Brandon & Tibbs, 226 Cal. App. 3d at 455-56 (direct damages as those which would normally be considered to arise in the usual course of events without any regard to special circumstances). For example, if real estate prices unforeseeably collapse after the design professional completes its work, then the owners losses from a falling real estate market are likely a consequential damage.

c. Recoverable Consequential Damages

To be recoverable, consequential damages must have been contemplated at the time the parties entered into the contract. Brandon & Tibbs, *supra*, 226 Cal. App. 3d at 455-56. The Brandon & Tibbs court based its reasoning upon *Hadley v. Baxendale* 156 Eng. Rep. 145 (1854). The Hadley Court adopted the following rule: that consequential damages are those that are secondary consequences of a breach and will only be available as compensation for breach of contract if they were within the reasonable contemplation of both parties at the time they entered into the contract. The requirement of “reasonable contemplation” allows the parties to allocate risk and determine whether to accept the risk of contracting. Brandon & Tibbs, 226 Cal. App. 3d at 457.

In Brandon & Tibbs, the Court held that lost profits can be consequential damages provided that they were expressly contemplated at the time the contract was made. Brandon & Tibbs, *supra*, 226 Cal. App. 3d at 457; see also *Grupe v. Glick*, 26 Cal. 2d 680 (1945) (an award of damages for loss of future profits is subject to the general rule that the amount which would have come to plaintiff be certain and have been within contemplation of the parties when they entered into the contract).

The parties’ ability to allocate risk is the essence of the decision in Hadley. Parties to a contract are deemed to have expected the normal and usual risks in the absence of specific contractual language to the contrary. Accordingly, general or direct damages, which represent the normal and expected risks, are always recoverable. However, consequential damages, which represent additional risks due to unusual circumstances of the non-breaching party, are not awarded unless the non-breaching party can establish that 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 the extra risks resulting from the non-breaching party’s unusual position. As long as a contract clearly spells out what the parties intended, a court will generally enforce it as written unless it is contrary to public policy.

While few California cases address the issue, the seminal case for consequential damages in a construction context is *Perini Corporation v. Great Bay Hotel & Casino*. 610 A.2d 364 (N.J. 1992), overruled on other grounds by *Howard Savings Bank v. Liberty Mut. Ins. Co.*, 667 A.2d 390 (N.J. Super. 1995). There, a construction manager was sued by the hotel operator because the construction project – the building of a hotel/casino – was completed four months behind schedule. The construction manager was sued for lost profits for the four months the casino was not open. Specifically, the delay was alleged to have occurred when the installation of an ornamental façade – whose only purpose was to attract walk-in traffic – was delayed. The construction manager was held liable for \$24 million in lost profits for the four month delay, even though the construction manager’s contract was a mere \$600,000 and the delay was over a minor, non-functional aspect of the project. The Court held that liability was appropriate because the casino repeatedly informed the contractor at the time of contracting that the failure to complete the project would result in lost profits from the summer tourist season.

Perini Corporation points out the dangers that can arise if the design professional fails to address consequential damages in its contract or, worse, if the design professional is forewarned of such damages in the event the project is delayed. Using the guidelines found in California common law,

design professional can be proactive so as to attempt to insulate themselves against a potential consequential damages award. They should consider attempting to negotiate a no consequential damages clause so that it is clear that the parties have directly addressed the issues of consequential damages and have allocated the risks of any foreseeable delays, lost profits, or diminution in value. By specifically addressing these items, courts will consider the parties to have allocated their respective risks and will respect those decisions.

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