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## LIMITING CONSEQUENTIAL DAMAGES

In recent years, there has been a greater realization that managing risk in the construction industry means limiting the scope of consequential damages for which a firm may be held liable. Now, with the tremendous growth in mold-related claims, it is more important than ever to achieve a limitation of consequential damages.

Mold claims—and indoor air quality claims in general—carry with them not only the possibility of extensive property damage and economic loss, but also bodily injury and lost productivity claims. While limiting exposure for consequential damages does not provide absolute protection from mold claims, it can effectively counter many egregious claims. Limiting consequential damages between parties means limiting those damages that do not flow directly from the acts of those parties. Although determination varies according to jurisdiction, consequential damages are usually identified as those that arise from the result of the act leading to liability.

### Standard Contracts Include Waivers

At the inception of a construction project, the financial risks and obligations of the parties seem to be self-evident. The client has agreed to pay the negotiated price for the construction of the project. The contractor retains the financial risk of whether the project can be constructed for the agreed upon amount. But there are many other risks. These usually are allocated through insurance or other risk-shifting mechanisms. The use of a mutual waiver of the right to recover consequential damages is one of the more recent developments in allocating risk.

Both AIA Document A201-1997, *General Conditions of the Contract for Construction*, and AGC Document 200, *Standard Form of Agreement and General Conditions Between Owner and Contractor (Where the Contract Price is a Lump Sum)*, establish a mutual, or reciprocal, waiver of all consequential damages claims between the client and the construction contractor.

The waiver of any right to consequential damages protects both the client and contractor from liability for inherently risky, difficult-to-manage, and often unidentifiable damages. Specifically, the client waives, among other consequential damages claims, claims for loss of use and for loss of income or profit. For instance, in AGC 200, the client waives “damages including but not limited to the Owner’s loss of use of the Project, any rental expenses incurred, loss of income, profit or financing related to the Project, as well as the loss of business, loss of financing, principal office overhead and expenses, loss of profits not related to this Project, or loss of reputation.” The right of the client to include a “liquidated direct damages” provision is maintained.

### Limiting Risk to Liquidated Damages

Often in a client-generated contract, “liquidated damages” are defined expansively. Liquidated damages are usually stated as a fixed amount per calendar day to cover damages sustained by the client. The stipulated sum of liquidated damages is limited only by a requirement that they be reasonable in the context of the entire contract. This means that liquidated damages usually include not only the client’s direct damages, but also the client’s consequential damages as a result of the contractor’s failure to complete the project on time. Using the concept of “liquidated direct damages” eliminates this exposure.

The difference between “liquidated damages” and “liquidated direct damages” becomes important in mold-related claims. The language used in A201-1997 and AGC 200 contemplates that there will be no element of consequential damages or loss of use included in the liquidated damages. If a contractor can show that the “liquidated

direct damages” provision also includes expected consequential damages, the provision may be unenforceable or enforceable only in part.

If mold is discovered in an unfinished project and that project is delayed by mold-damaged components that need to be replaced, the direct damages and delays may be significant. Limiting the delayed start-up costs to liquidated damages can help the firm manage its exposure. Eliminating the specter of consequential damages can preserve the continued financial viability of the firm.

### **Delays and Costs Due to Mold**

Mold problems that become apparent during the construction process may cause an inexcusable delay that requires the client to pay increased costs for financing the project. In addition, the loss of use and increased borrowing costs are two forms of consequential damages that may force a client to reevaluate its financial expectations for the project and consider making a claim against the contractor. The contractor may discover that the client’s claim for consequential damages far exceeds the client’s claim for direct losses, thereby exacerbating legal defense costs and reducing the possibility of timely resolution or settlement.

Even with a waiver of consequential damages in place, the client still has the ability to recover for direct damages. These costs could include the expense of repairing defective construction, the diminution in value of the property, and liquidated damages. Diminution in value is measured by the difference between the market value of the defective project as delivered by the contractor and the value the project would have had if the contractor had completed it in accordance with the contract. In the case of a mold-infested project, the entire facility may be considered a loss because the cost of repairs would result in “economic waste,” or the public awareness of mold-related problems could make the property either unusable or difficult to sell.

### **Insurance Treatment of Consequential Damages**

Increasingly, consequential damages will be a subject of insurance coverage disputes. This is especially true when the consequential damages can be traced to evidence of mold. Insurance carriers for contractors and construction projects are attempting to limit their exposure to mold claims. This is driven to a large extent by the expanded liability for consequential damages being developed through case law based on the “foreseeability” of the damage.

Few insurance products cover the client’s consequential damages. While the client may not be able to recover mold-related and consequential damages in general from indemnity policies such as commercial general liability or contractor pollution liability, the client may be able to recover against first-party policies such as builder’s risk.

Under a typical CGL policy, the insurer owes the insured the duty to defend suits against the insured that seek damages on account of bodily injury or property damages arising from an occurrence. The insurer also owes the duty to indemnify the insured if a covered claim results in a judgment against the insured. Some CGL policies specifically exclude the type of consequential damages for which an insured may seek recovery. Mold claims are now generally excluded; other claims that could generate significant consequential damages also may be specifically excluded. In some cases, the client may be able to recover consequential damages such as economic loss—lost income, lost profits, or damages sought by a third party for the loss of use of its property—if they relate to the client’s loss of use of the property due to the contractor’s defective work. Again, mold allegations invariably trigger an exclusion.

Builder’s risk policies, which cover the project while it is under construction, renovation, or repair, may provide coverage for a wide array of consequential damages. These policies also may be the last to cover mold-damaged materials stored onsite or already incorporated into an incomplete project. For a builder’s risk policy to cover

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consequential damages arising from a loss, the event causing the loss must be an “insured event” that causes damage to “insured property.”

**Negotiation Difficulties**

As the construction industry enters a time of greater competition for fewer projects, clients may be less willing to negotiate waivers of consequential damages. But as the consequences of a direct loss caused by a contractor may become even more financially challenging because of the possibility of mold-related claims not subject to insurance coverage, the negotiation of a reasonable limitation on risk becomes vital.