

# **CONSEQUENTIAL DAMAGES** **WHO PAYS THE REAL PRICE?**

---

Porter Hedges LLP Construction CLE Breakfast  
May 15, 2018  
Houston, Texas

Allison J. Snyder  
Kyle C. Reeb

**PORTER HEDGES LLP**  
1000 Main Street, 36<sup>th</sup> Floor  
Houston, Texas 77002  
{713} 226.6000 Tel  
{713} 228.1331 Fax  
asnyder@porterhedges.com  
kreeb@porterhedges.com

# PURPOSE OF CONSEQUENTIAL DAMAGE WAIVERS

- To limit or eliminate consequential damages.
- To remove the uncertainty and unpredictability surrounding an award of consequential damages.

## INTERPRETATION: IS IT DIRECT OR IS IT CONSEQUENTIAL?

### ➤ *Arthur Anderson & Co.* (Tex. 1997)

- Direct Damages – “Flow naturally and necessarily from the wrong”
- Consequential Damages – “Result naturally, but not necessarily, from the defendant’s wrongful acts . . . must be foreseeable . . . and must be directly traceable to the wrongful act and result from it.”
- So, what does this mean? Let’s look to the recent Texas case law.

# CASE LAW HISTORY

- *Tennessee Gas Pipeline v. Technip USA Corp.* (Tex. App.—Houston [1<sup>st</sup> Dist.] 2008)
- *Cherokee County Cogeneration v. Dynegy Marketing* (Tex. App.—Houston [14th Dist.] 2009)
- *Reynolds Metals Co. v. Westinghouse Elec. Corp.* (5<sup>th</sup> Cir. 1985)
- *Powell Electric Systems v. Hewlett Packard* (Tex. App.—Houston [1<sup>st</sup> Dist.] 2011)
- *Balfour Beatty Rail Inc. v. Kansas City Railway* (N.D. Tex. 2012)
- *Kiewit Offshore v. Dresser-Rand* (S.D. Tex. 2016)

## INCONSISTENT INTERPRETATIONS, OR CAN WE RECONCILE?

- Seemingly Identical Damages Have Been Held to Be Direct Damages in Some Cases and Consequential Damages in Other Cases
- For Example:
  - Courts Have Sometimes Considered **Lost Profits**, Direct Damages and Other Times, Consequential Damages
    - *Tennessee Gas Pipeline* (2008)
    - *Cherokee County Cogeneration* (2009)
- How do we square these courts' opinions?

## *TENNESSEE GAS PIPELINE*

### ➤ Facts:

- TGP contracted with Contractor to replace and upgrade six compressors.
- A 17 month project turned into 3 years.
- TGP sued Contractor for damages:
  - lost profits
  - project delay costs
  - loss of efficiency
  - extended power
  - backup generator rental
  - premature energy costs
  - allowance for funds during construction
- Contractor argued these are all consequential excluded by the contract.

## ***TENNESSEE GAS PIPELINE***

### ➤ Consequential Damages Waiver:

- Notwithstanding any other provisions of this Agreement to the contrary, in no event shall Owner or Contractor be liable to each other for any indirect, special, incidental or consequential loss or damage *including, but not limited to, loss of profits or revenue, loss of opportunity or use* incurred by either Party to the other, or like items of loss or damage; and each Party hereby releases the other Party therefrom.

## COURT'S HOLDING CONCERNING LOST PROFITS

- TGP sought lost profit from the sale of gas to its customers.
- “Lost profits can take the form of direct or consequential damages.”
  - If the profits are lost **on the breached contract itself**, then the profits are likely direct damages.
  - But if a party's expectation of profit is merely **incidental** to the performance of the contract, the loss profits are likely consequential.
- **Held:** Lost profits = consequential because the owner's expectation of profit through the sale of gas to its customers was incidental to the performance of the contract.

## COURT'S HOLDING CONCERNING OTHER DAMAGES

- When addressing the remaining damages alleged by TGP, the court found the following:
  - Direct damages
    - Project delay costs (admin., labor, travel, consumables, utilities, etc.)
    - Damages arising from providing extended power (loss of anticipated savings on projected efficiency of new compressors)
  - Consequential damages
    - Loss of efficiency
    - Cost of backup generator rental during a power outage
    - Loss of borrowing power on interest on money TGP might have accrued during construction
    - Premature energy costs
- The only direct damages were those costs expressly imposed on TGP by the Contract.

# ***CHEROKEE COUNTY COGENERATION***

## ➤ Facts:

- Dynegy (supplier of natural gas) and Cherokee County (purchaser) entered into a Gas Purchase Agreement.
- Dynegy breached the contract and Cherokee County sued.
- Cherokee County sought damages under a formula set out in the Contract for the market value of the gas not received (difference between commodity change and the market price).
- Dynegy argued that the Cherokee County was merely seeking consequential damages for any “lost profits” the Cherokee County might have realized by reselling gas to third parties at a higher market price.

# ***CHEROKEE COUNTY COGENERATION***

- Consequential Damages Waiver:
  - The remed[y] specified in Section[ ] . . . 5.2 above shall be the sole and exclusive remed[y] for . . . Seller's failure to deliver gas according to this Agreement. Neither party shall be liable in any event for consequential, incidental, special or punitive damages or losses which may be suffered by the other as a result of the failure to deliver . . . the required quantities of gas.

## COURT'S HOLDING CONCERNING LOST PROFITS

- Lost profits on the contract itself = direct damages.
- The Parties' contract contemplated Purchaser's ability to profit from resales of the purchased gas at a higher price.
- Lost profits on other contracts for the sale of electricity produced by the cogeneration facility are consequential damages.

# REYNOLDS METALS CO.

## ➤ Facts:

- Reynolds bought a transformer and installation services from Westinghouse.
- Under the parties' contract, Westinghouse was required to provide an engineer to check and inspect the start-up of the unit.
- The contract also contained a waiver for all special, indirect, incidental or consequential damages.
- The transformer failed less than a year after installation.
  - Limitations had run on warranty, negligence and strict liability claims
  - It was past the warranty period.
- Reynolds sued Westinghouse for breach of contract (transformer repair costs).

## REYNOLDS METALS Co.

- Typically, construction contracts include:
  - Provisions that speak to how the work will be performed; and
  - Specific remedies relating to repairing defective work.
- These provisions will usually mean that repair costs are considered to be direct damages.

# COURTS HOLDING CONCERNING REPAIR COSTS

- **Held:** transformer repair costs = CONSEQUENTIAL
- How can this holding be explained?
  - The court turned to what caused the alleged breach.
  - In *Reynolds*, it was the purported failure to provide a competent engineer.
  - Therefore, the presumed benefit of the contract was not a functioning transformer, but the value of a competent engineer.

# POWELL ELECTRIC SYSTEMS

- Owner hired Contractor to perform retrofitting services; more specifically, to remove breaker cables and reconnect them to transformers.
- Contractor accidentally crossed certain breaker cables on reconnection, causing one transformer to fail.
- Owner sued Contractor for
  - cost of a temporary transformer; and
  - transformer repair costs.

# POWELL ELECTRIC SYSTEMS

- Consequential Damages Waiver:
  - Neither Party shall be liable for any consequential damages (including without limitation, lost profits and unliquidated inventory), indirect, special, or punitive damages even if the other party has been advised of the possibility of such damages.

# COURTS HOLDING CONCERNING REPAIR COSTS

- **Held:** transformer repair costs = DIRECT
  - **Reason:** The contract said that:
    - *Powell promises to “pay for damages to other work” resulting from a breach of its warranty;*
    - *HP would reimburse Powell for damaged work, if not caused by Powell’s breach of negligence*
    - *HP would not reimburse Powell for Powell’s negligence*
  
- **Held:** temporary transformer = CONSEQUENTIAL
  - HP had 2 transformers. Facility was designed to operate on 1.
  - *i.e., Could not be “conclusively foreseen by Powell that losing 1 transformer would result in procurement of temporary transformer.”*

- What's the difference between *Reynolds* and *Powell*?
  - *Reynolds*: claim was limited to the improper installation—a step removed from the causal element of the damaged transformer, i.e., design defect.
    - Contract did not mention damage to other work or repairs.
  - *Powell*: although the claim related to improper installation work—the contract contemplated that negligent work would result in damage, and
    - that Powell would “pay for damages to other work”.

# BALFOUR BEATTY RAIL INC.

## ➤ Facts:

- Owner (KCSR) hired Contractor (Balfour) to complete a railway track line.
- Contract set completion for May 2009, however, Balfour did not complete the project until July 2009.
- Because of the delay, KCSR rents tracks from Union Pacific paying \$1.3MM in “trackage fees.”
- KCSR sues Balfour to recover the “trackage fees.”

## BALFOUR BEATTY RAIL INC.

- Consequential Damages Waiver:
  - Neither party will be liable to the other for consequential, indirect, or punitive damages for any cause of action, whether in contract, tort or otherwise. Consequential damages include, but are not limited to, lost profits, lost revenues, and lost business opportunity, **whether the other party was or should have been aware of the possibility of these damages.**

- KCSR argues the trackage fees are direct damages because:
  - The contract has a “time is of the essence” clause, and
  - KCSR’s website contains a newsletter stating that completion of the rail would allow it to reduce its costs by 40% by eliminating trackage fees paid to Union Pacific
  
- Balfour argues that this is a “loss of use” claim, and
  - Although waiver does not list “loss of use,” it is also not “limited” to the losses listed, and
  - The contract did not mention trackage fees as potential damages

## COURTS HOLDING CONCERNING DELAYS

- **Holding:** KCSR's Trackage fees = CONSEQUENTIAL
- **Strangely:** in reaching the decision the court performed an extensive analysis as to whether Balfour had knowledge of KCSR's newsletter or of the potential for trackage fees because of delay.
- **Typically:** The analysis begins and ends with whether the potential damage is (1) mentioned in the contract, and (2) involves a third-party. [Existence of a fact beyond relationship of the parties]
- **Ultimately:** The Court reached the operative fact that "although the Contract states that '[t]ime is of the essence,' it says nothing about the potential consequences to KCSR for BBRI's failure to complete the track construction within the time specified by the Contract."

## BALFOUR: FORESEEABILITY

- Why consider Contractor's subjective knowledge, when the consequential damages waiver on its face should preclude third-party trackage fees for loss of use?
- Seemingly, the *Balfour* court applied a "foreseeability" standard for determining whether consequential damages are recoverable absent a waiver, even though the contract contained a waiver.

## WHEN YOU HAVE NO CONSEQUENTIAL DAMAGES WAIVER: FORESEEABILITY TEST

- “Foreseeability is a fundamental prerequisite to the recovery of consequential damages for breach of contract.” *Basic Capital Management* (Tex. 2011) cites Restatement (Second) of Contracts approvingly.
- Restatement: Damages not recoverable for loss if the party “had no reason to foresee” damage “when the contract was made”
- Foreseeability is found where loss follows from the breach:
  - In the ordinary course of business; or
  - As a result of special circumstances that breacher “had reason to know”

# KIEWIT V. DRESSER-RAND

## ➤ Facts:

- Dresser-Rand (“D-R”) retained Kiewit to design, engineer and fabricate two modules, for ultimate use by D-R’s customer, PEMEX.
- The agreed price was \$27MM, unless change orders were requested by Kiewit and approved in writing by D-R.
- Significant changes occurred—Kiewit did not seek change orders, but:
  - D-R agreed to increase the contract price to \$33MM.

# KIEWIT V. DRESSER-RAND

## ➤ Facts *continued*:

- Kiewit demanded an additional \$9MM for costs to accelerate efforts (including paying its subs more) claiming that:
  - D-R breached its contractual obligation to provide “key technical data to Kiewit.”
  - Kiewit called these “project impact damages.”
  
- D-R counterclaimed to recover \$1.3MM in liquidated damages assessed by PEMEX, because Kiewit’s work was late

# KIEWIT V. DRESSER-RAND

## ➤ Consequential Damages Waiver

- The contract included a contractual limitation of liability waiving the ability of Kiewit and Dresser-Rand to collect from each other “consequential, special, punitive, or indirect damages, including but not limited to lost profits or business interruption, however same may be caused. The term ‘consequential damages’ includes but is not limited to, **loss of production**, loss of profits, loss of business, and loss of use.”

# COURT'S HOLDING CONCERNING PEMEX LDs

- PEMEX LDs = CONSEQUENTIAL
  
- *Reasoning*: though Kiewit was aware that the modules were intended for PEMEX
  - The LDs stemmed from a third-party contract; and
  - Kiewit's contract with D-R was silent on the issue.

# COURT'S HOLDING CONCERNING PROJECT IMPACT DAMAGES

- Kiewit's project impact damages = DIRECT
- *Reasoning*
  - They were confined to the parties' relationship; and
  - stemmed solely from D-R's alleged failure to meet its obligations to Kiewit (i.e. to "provide key technical data"), which interfered with Kiewit's ability to perform under the Contract.
- "Loss of production" waiver related to lost *oil production*, **not** loss of productivity in completing the project.

# TAKEAWAYS

## TAKEAWAYS

- Loss of use/opportunity/profits, may be direct damages where they are profits on the contract, itself. (*Tennessee Gas Pipeline & Cherokee County Cogeneration*)
- Though Texas courts will generally respect the parties' contract, attempting to classify a damage as direct or consequential is not dispositive of the issue—the courts will closely examine the circumstances giving rise to the claim. (*Tennessee Gas Pipeline*)
- Incorporate repair cost expectations directly into the contract. (*Powell*)

## TAKEAWAYS

- A contract schedule and a “time is of the essence” clause will not preserve all delay claims from a consequential damages waiver (*Balfour*)
- Without express entitlement to certain damages, anticipate having to present evidence of actual knowledge at the time of contracting. (*Balfour*)(*Kiewit*)

## TAKEAWAYS

- Breaches that interfere with another party's ability to perform under a Contract—classified as “project impact damages” or “disruption damages”—may qualify as direct damages. (*Kiewit*)
- Contemplate third-party contract damages, upstream and downstream, and address them in your contract. (*Kiewit*)

## TAKEAWAYS

- Contemplate what type of damages you want to recover that might be consequential unless addressed by your contract.
- Make your damages “foreseeable” through the contract.
- Review contracts for ambiguity or potential conflicts and ensure that all contracts avoid “unconscionability.”

# DRAFTING STRATEGIES

## DRAFTING STRATEGIES

- *Contemplate the direct damages that each party believes might stem from a breach of the contract.*

## DRAFTING STRATEGIES

- *Clearly define what consequential damages are going to be included or waived.*

## **POTENTIAL CONSEQUENTIAL DAMAGES – OWNER**

- Loss in Professional Reputation
- Loss of Business Opportunities
- Loss of Profits/Loss of Production/Loss of Power
- Cost of Forfeited Bonds or Deposits, Penalties or Tax Implications
- Diminution in Value
- In delay claims:
  - Escalation in Material and Labor Cost
  - Rental and Storage Expenses
  - Increased Insurance Costs
  - Delay Damages Owed to Other Project Participants
  - Delay Damages Owed to Owner/End User
  - Increase in Professional Design Services Fees
  - Increase in Management and Personnel Expenses
  - Loss of Use (other than loss of profits)
  - Additional Financing Costs

## **POTENTIAL CONSEQUENTIAL DAMAGES – CONTRACTOR/SUBCONTRACTOR**

- **Loss in Professional Reputation**
- **Loss of Business Opportunities**
- **In delay claims**
  - **Lost Profits on Other Work**
  - **Loss in Bonding Capacity**
  - **Loss in Funding Capacity, Additional Financing Costs**
  - **Escalation in Material and Labor Cost**
  - **Loss of Use of Equipment**
  - **Loss of Productivity**
  - **Extended General Condition Costs**
  - **Home Office Overhead Expenses**

## DRAFTING STRATEGIES

- Considering the lack of a clear definition for consequential damages, be as specific as possible in defining what is being waived (e.g., lost profits, loss of business reputation, loss of use, etc.).
- When Texas courts interpret the parties' waiver language, the courts will respect the parties' intent if it is clear and listed.
- If you really want to ensure waiver, waive damages, whether direct or consequential.

## DRAFTING STRATEGIES

- Consider other provisions of the general contract that might later be seen as inconsistent with the waiver or inclusion of consequential damages.
- Make sure the direct damages you anticipate receiving due to a breach have not been waived.

## DRAFTING STRATEGIES

- Consider placing a **cap** on all damages.

## DRAFTING STRATEGIES

- Ensure the consequential damages are not waived in the general contract flow down to the subcontract.
  - If contractor is going to be held liable to the owner for a defined type of consequential damage (i.e., lost profit) pursuant to the prime contract, then contractor should consider defining that same category of damage as “direct damages” in its subcontracts.

## **STANDARD EXAMPLE**

### **➤ 15.1.6 AIA Document A201 (2007)**

#### **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 15.1.6 shall be deemed to preclude an award of liquidated damages, when applicable, in accordance with the requirements of the Contract Documents.

# EXAMPLE

- The Owner waives, and will require its insurers to waive rights of subrogation with respect to, all liability for Owner's consequential, special, indirect or incidental damages arising out of or relating to this Contract. *In addition, the following damages, whether consequential, direct, or otherwise, are also waived:*
  - damages incurred by the Owner for rental expenses, for losses of use, loss of business opportunity, loss of product or output, income, loss of profit or revenue, cost of capital, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and
- The Contractor waives all liability for Contractor's consequential, special, indirect or incidental damages arising out of or relating to this Contract. *In addition, the following damages, whether consequential, direct, or otherwise, are also waived:*
  - 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.

## EXAMPLE

- Notwithstanding anything else in this Contract to the contrary, no Party shall be liable to the other for any loss of profits, lost revenue, loss of opportunity, loss of goodwill, cost of capital or any indirect, consequential, incidental, special, punitive or exemplary damages resulting in any way from, arising out of or in connection with performance or a failure to perform any obligation under this Contract, whether or not foreseeable, and regardless of whether liability is based on breach of contract or warranty, tort (including negligence, gross negligence, and strict liability) or other bases of liability.

## EXAMPLE

### 14.4 Consequential Damages

In no event, except to the extent the liquidated damages provided for in Article 13 or the indemnity obligations described in Sections 23.1 and 23.2 may be construed to cover such damages, whether as a result of breach of contract, warranty, guarantee, indemnity, tort, including negligence, strict liability or otherwise, shall either Party hereto or any Subcontractor be liable for indirect, special, incidental or consequential damages, including but not limited to, the loss of profits or revenue, loss of use of any equipment, down time costs, loss of opportunity, loss of goodwill, cost of purchased or replacement power, claims of customers of the other Party for such damages, and/or governmental penalties or sanctions imposed on Owner (except as provided in Section 23.5); Owner hereby releases Contractor and all Subcontractors, and Contractor hereby releases Owner, therefrom.

## EXAMPLE

7.5 **Consequential Damages.** Neither Owner nor Contractor (or any Subcontractor that provides a reciprocal waiver to Owner) will be liable for any consequential, special, incidental, or indirect damages, sustained by the other or any of such other Party's (or any such Subcontractor's) respective parents or affiliates, including loss of profit, loss of revenue, loss of use, loss of goodwill, loss of opportunity, loss of shop space, loss of business, loss of contract, loss of data, cost of capital, repayment of capital, down time costs, costs of utilities, cost of replacement power, and claims of customers. The foregoing limitation is not intended to limit a Party's liability to any Person indemnified under this Agreement. The Parties agree that any liquidated damages and bonus amounts provided under this Agreement, or the direct damages of Owner payable by Contractor in connection with the termination of this Agreement because of a Contractor Default, will not be considered "consequential, special, incidental, or indirect" damages under this **Section 7.5**.

# QUESTIONS?

---

Allison J. Snyder  
Kyle C. Reeb

**PORTER HEDGES LLP**  
1000 Main Street, 36<sup>th</sup> Floor  
Houston, Texas 77002  
{713} 226.6000 Tel  
{713} 228.1331 Fax  
asnyder@porterhedges.com  
kreeb@porterhedges.com