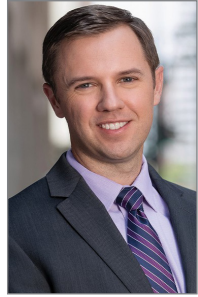


# A primer on waivers of consequential damages

Whether for a minor remodel or a large-scale tenant improvement, most construction contracts include a waiver-of-consequential-damages provision, under which both parties waive all claims for consequential damages. Building owners and landlords should understand both the potential consequences of agreeing to such a provision and the available alternatives to ensure losses are recoverable.

Understanding the potential consequences of a mutual waiver-of-consequential-damages provision requires a brief foray into the basics of contract law. The scenario in which this provision applies assumes that two parties have entered into an enforceable contract and that one of those parties has breached the contract by failing to perform its obligations. Generally, there are two types of damages arising out of a breach of a contract: compensatory damages covering losses that the nonbreaching party incurred as a direct result of the breach and consequential damages covering losses that flow indirectly from the breach, such as loss of rental income, rent abatement, loss of reputation and relocation costs. A waiver-of-consequential-damages provision prevents the nonbreaching party from recovering this second category of losses.

As an example, take a scenario where a building owner seeks to attract a steady tenant by remodeling an existing commercial space into a new restaurant, including a



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commercial kitchen, dining area and outdoor patio. The owner engages a contractor to build out the space. The construction contract sets a completion date at the start of summer to maximize patrons' interest in the outdoor patio. Simultaneously, the owner enters into a lease with a tenant to occupy and operate the restaurant, with payments due under the lease commencing on the expected completion date. Relying upon the anticipated completion date, the tenant hires a chef, a manager and other employees, it purchases advertisements for a grand opening, and it orders furniture, fixtures and equipment. However, the contractor badly underestimated the time necessary to perform the work, and the restaurant opens four months later than expected, just as fall arrives. The tenant incurs significant damages related to the delay, including payment for services it could not use, lost revenues, a tarnished reputation and storage costs for the furniture, fixtures and equipment, all of which the tenant seeks to recover from the owner under the lease. In addition, the owner suffers significant damages in the form of loss of rental income, loss of profit sharing and rent abatement.

In this scenario, what damages is the owner entitled to recover

from the contractor? The answer depends upon whether the construction contract included a waiver-of-consequential-damages provision. If so, then the owner likely will be limited to recovering compensatory damages (e.g., property taxes, utility bills and professional



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services for the period of delay); and will be prevented from recovering consequential damages (e.g., loss of rent, rent abatement, interest carry on the construction loan, and damages owed to third parties, including the tenant). This outcome can be a bitter pill for an owner to swallow at the end of a troubled project, particularly if the owner was not fully aware that these damages were being waived.

The most obvious way to avoid this outcome would be for the owner to reject the waiver-of-consequential-damages provision in the contract. However, the owner likely will have a difficult time doing so because such provisions are considered typical in the current market – contractors have little incentive to “bet the company” on a single construction project by exposing themselves to the owner's consequential damages, which are inherently unpredictable.

The next best way to avoid this outcome would be for the owner to

require a liquidated damages provision in the contract to compensate the owner from losses resulting from the breach – direct and indirect, compensatory and consequential. As a general rule, an owner should never agree to a mutual waiver-of-consequential-damages provision unless there is a liquidated damages provision elsewhere in the contract. To be most effective, however, it is critical that the liquidated damages provision accurately project all of the costs that the owner or landlord expects to incur as a result of the delay. If the liquidated damages rate is set too low or is capped, the owner may not be adequately protected.

Finally, if the contractor is not willing to agree to liquidated damages but also is insisting on a waiver-of-consequential-damages provision, then the best way for the owner to protect itself is to carve out exceptions to the provision. For example, the owner could identify certain kinds of losses (e.g., rent abatement) that are exempted. Alternatively the owner could state that the provision does not apply to consequential damages that are paid by insurance applicable to the project. While these exceptions may not make the owner whole, they may strike an appropriate balance between protecting the owner from loss while not exposing the contractor to an unquantifiable risk. ▲

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