

Bulletin #67, Limitation on Damages' Clauses – We Made a BIG Mistake! (May 30, 2003)

The worst of any imagined call arrives. You have been accused of incorrectly installing an HVAC system. The system needs to be completely ripped out and replaced. The whole project will be delayed, and the general contractor and owner are out of control!

Is there anything you can do to limit your liability?

It may depend on the language of your contract.

If an “Act of God” caused the problem, and your contract contains a force majeure clause (see [Contracts Bulletin #65](#)), you may have a complete defense to liability. However, if your workers caused the problem, you will need to contact your insurance company (see [Contracts Bulletins #13](#) and [#57](#)). Regardless of your insurance coverage, your contract may contain clauses which limit your financial responsibility (damages) for the mistake.

Definitions

Many contractors and owners place limitations on damages' clauses in contracts. It is important to understand, and be familiar with the two types of clauses that are frequently used:

Liquidated Damages' Clause: This clause in a contract lists a specific amount a party will pay in damages for breaching a contract or causing injury. These specified damages must be reasonable and cannot be a penalty. For example, a contractor will pay a specific agreed upon amount (i.e., \$300 per day) as liquidated damages for delays in completion of a project.

Limitation on Consequential Damages' Clauses: These clauses limit damages for losses that are directly caused by a breach, and do not include any other damages. For example, an HVAC system may fail, and the direct damages are the costs of repairing the HVAC system. Consequential damages could include any personal injury which may have resulted from the failure (i.e., if it collapsed and fell on someone), and the damages which resulted from the delay in the overall project, including interests' costs, costs incurred by other contractors, lost profits, etc. A limitation of consequential damages' clause prevents the contractor from being liable for more than the direct damages, and may place a cap on the amount the contractor will have to pay.

In the absence of either of these two clauses, a party who breaches a contract or otherwise causes an injury **will** be liable for the full damage that is caused, including the direct damages, as well as any consequential damages resulting from the wrongful act.

Example Clauses

In order to limit damages and create some certainty for recovery, owners and contractors often enter into provisions which limit their damages. AIA contracts contain such provisions, and are the most commonly used:

4.3.10 Claims for Consequential Damages. The Contractor and Owner waive all claims against each other for all 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 the 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 subparagraph 4.3.10 shall be deemed to preclude an award of liquidated direct damages, when applicable, in accordance with the requirements of the Contract Documents.

AIA Document A201–1997, Paragraph 4.3.10

Likewise, a recent case discussed, and enforced a contract containing both limitations on consequential damages and clauses containing specified liquidated damages:

Article XV Waiver of Consequential Damages

In no event shall Seller be liable to [Buyer] whether in contract, warranty, tort (including negligence or strict liability) or otherwise for any special, indirect, incidental or consequential damages of any kind whatsoever.

Article VIII Liquidation Damages

. . . [Contractor's] maximum limit of liability under this Agreement as to any . . . [failure] shall be 10% of the Lump sum fee received by the [Contractor] . . . These payments are exclusive remedies to the [Owner] under this Agreement. Except as provided in the Article VIII, the Contractor shall have no other liability whether in contract, warranty, tort or otherwise.

Mistry Prabhudas Manji v. Raytheon Engineers & Constructors, 213 F.Supp.2d 20, 25 (D.Mass. 2002).

Limits on Using These Clauses

Damages' provisions are not enforceable if they are merely a 'penalty.' For example, if a liquidated damages' clause provides that the contractor is responsible for liquidated damages of \$1,000,000 per day

for any delays in completion of the project, and the total cost of the project is only \$10,000,000, then the courts will refuse to enforce the liquidated damages' provision as an unenforceable penalty.

Limitation on consequential damage clauses and liquidated damage clauses are widely enforced by the courts. However, courts refuse to enforce these provisions when they are contrary to the parties' intent. For example, if conflicting provisions in a contract demonstrate that the parties intended that consequential damages are recoverable, the courts will not enforce a damage limitation provision. [See *Centex–Rogers Construction Company v. McCann Steel Company*, 426 S.E.2d 596 (Ga.App. 1992)]. In the *Centex* case, the court refused to rule that the plaintiff was limited to the liquidated damages. The contract contained another provision which said that the liquidated damages' clause did not prevent other recovery, so the plaintiff received consequential damages.

The provision must also be "mutual." In the AIA clause above, there are limitations on **both** the contractor **and** the owner's ability to recover. If the provision is one–sided, and there is no arguable benefit to both parties, then courts will be more reluctant to enforce the provision. However, courts will still review the language of the contract and attempt to determine the parties' intent.

Finally, a defense to these provisions that is often asserted (and rejected) is that they are "unconscionable." Unconscionable is a legal term for a provision that is fundamentally unfair and biased in favor of one party. Specifically, a party may argue the unconscionable provision is the result of a lopsided bargaining power. Courts universally reject these arguments in agreements between businesses. The fact that one business is very large, and the other is small in a commercial transaction is not generally grounds to refuse to enforce a provision as unconscionable.

Lessons

Courts' refusal to reject provisions as unconscionable provides an important lesson to everyone who signs contracts. Those of us who work in the construction industry often see multi–page contracts (including AIA contracts) that have numerous provisions. These contracts seem too lengthy to bother to read and understand. However, courts repeatedly enforce these provisions, because (regardless of size) businesses are expected to read and understand their contracts.

If you are presented with a liquidated damages' provision that imposes substantial liability in the event of delay, you likely **will** be held responsible under that provision. Likewise, if you include a provision which limits your exposure for consequential damages as the result of a mistake, then the courts are also likely to force that provision.

In the event of a "big" mistake, liquidated damages and limitation on consequential damages' clauses may have an enormous impact on your business. Therefore, when reviewing contracts, you should consider the following:

- If you use your own contract, you should consider adding liquidated or limitation of consequential damages provisions (if you think they are appropriate);
- If you sign AIA contracts, look for these provisions and make sure they are acceptable; and
- If you are presented with contracts drafted by someone else, you **always** need to carefully read the contract before you sign to make sure it does not impose damages' provisions which you do not want to accept.

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