Waivers of *Consequential Damages*: Banish the Term

(It Doesn't Mean What Your Clients Think Anyway)

By Jeffrey S. Ammon

This is the author's third column on supposed terms of art in contracts. (The other two appeared in October 2014 and February 2016.) I believe they are unique in the literature—certainly in the plain-language literature. My thanks to Mr. Ammon for these contributions. —*JK*

Consequential-damages waivers are a common part of contract boilerplate. A typical example: *Client waives all claims for consequential damages suffered as a result of Consultant's breach of this agreement.*[1] But the term *consequential damages* does not mean what most clients think it means. Worse, clients have conflicting opinions about what it means. The solution: banish the term from your damage waivers.

First, let's set the record straight: Michigan courts define *consequential damages* (at common law) to mean damages that arise from the innocent party's unique or special circumstances that the breaching party knew about when the contract was made.[2] (Michigan's Uniform Commercial Code defines *consequential damages* differently to include many kinds of direct damages.[3] This article addresses common-law contracts only, not those governed by the UCC.)

Now observe how the following consequential-damages definitions, suggested to me by business executives and their advisers, are all incorrect:

- "Any loss you suffer as a consequence of our breach." (No, consequential damages are only one kind of damages recoverable for a breach. And some damages that are a "consequence" of the breach are not recoverable at all.)
- "Any damages you suffer beyond the cost to repair." (No, only some of those damages would be consequential damages.)
- "Lost profits." (No, lost profits can often be direct, nonconsequential damages. So a consequential-damages waiver may not waive all lost profits.[4])
- "Any loss that we, the party at fault, wouldn't have expected, especially if it's a big number!" (No, unforeseeable damages are never recoverable for breach of contract. A consequential-damages waiver would be unnecessary to protect against liability for unforeseeable damages.)
- "Anything our CGL [commercial general liability] insurance policy won't cover." (No, the term's definition has nothing to do with applicable insurance coverage. CGL policies typically cover only bodily injury, death, and property damage, and only if they arise out of a policy "occurrence." Insurance may or may not cover some consequential damages.)

So a waiver reciting *consequential damages* misleads the average contract signer because the term refers to a much narrower class of damages than most suppose. The signer protected by the waiver will have a false sense of security, counting on more protection than the waiver provides. And the signer who waives consequential damages will believe that much more has been given up than actually was.

The adjective *consequential* is the culprit: its ordinary meaning leads a person to conclude that the term refers to anything that is a "consequence" of the breach. But such an interpretation is both under- and over-inclusive, as we'll see. And the sometimes-used alternative label *special damages* is no better, because it merely replaces a misleading adjective with an inscrutable one.

An example

The following example illustrates the false sense of security that a contract party may have after negotiating for a consequential-damages waiver.

Suppose that a manufacturer proposes contracting with a builder to construct a new manufacturing plant. The builder fears bankruptcy from a catastrophic building

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collapse that gives rise to claims of faulty construction, however unlikely. The builder knows that such a collapse could cause huge losses to the manufacturer, including lost profits, temporary relocation, and rental expenses from not being able to use the facility until it was rebuilt, along with judgments and defense costs from wrongful-death lawsuits brought by the families of people killed in the collapse. So the builder insists that the manufacturer waive its right to collect "consequential damages," believing that this waiver will cover the damages it fears most. Assume that the manufacturer agrees to the waiver, although reluctantly.

Shortly after the manufacturer begins operations in the completed building, its roof collapses because of faulty construction. Employees and guests are killed, and the plant will be entirely unusable during rebuilding, expected to take a year.

Would the consequential-damages waiver protect the builder from damages it was most concerned about? No, much to the builder's horrified surprise. Why? None of the damages are due to the manufacturer's unique circumstances, so none of the damages satisfy the first part of the consequential-damages definition (that the loss arises from the manufacturer's "unique" or "special" circumstances). Any reasonable builder would expect, as this builder did, that a plant with a collapsed roof would be unusable during rebuilding. So the manufacturer's lost profits and its relocation and rental expenses would be recoverable. Same for the judgments and defense costs for wrongful-death lawsuits. These were also foreseeable, since any builder would know that the building would be occupied.

Can the drafter avoid misunderstandings by sticking with a clause waiving consequential damages, and then merely tacking on descriptions of specific kinds of damages that the drafter intends to include within the term *consequential damages*? No: this introduces ambiguity without eliminating the misleading nature of the *consequential damages* term. Assume that the manufacturer's waiver had read: *Manufacturer waives its right to collect from the builder all consequential damages, including lost profits* . . . . Does the drafter intend this clause to waive lost profits only if the lost profits are deemed consequential damages? Or does the drafter intend this clause to waive lost profits even if, as in our example, they happen to be direct, nonconsequential damages?[5]

An understandable waiver

Stop drafting in code! Let's draft damage waivers using words that our clients can understand, without using the misleading and misunderstood term *consequential damages*, and even if it requires more words. The sample below avoids that term. Instead, the sample offers clarity by waiving specific kinds of damages that clients and their advisers can readily understand.

You will need to tailor this sample extensively for each contract. Doing so will expose complexity that remains masked (and unaddressed) in the typical consequential-damages waiver. You will need to base your drafting on an exploration of the following:

- What are the most likely, or most catastrophic, causes of damages? (Delay in completion, building collapse, etc.)
- What kinds of damages are likely to arise? (Lost profits, temporary relocation expenses, increased transportation costs, third-party lawsuits for wrongful death, failure to fulfill accepted customer orders, etc.)

Sample Damage Waiver

Waiver. The manufacturer waives claims against the builder for the following damages, to the extent caused by the builder's breach of this agreement [and regardless of whether any of these damages would be classified as consequential, special, direct, indirect, incidental, or otherwise]:

(a) lost profits;

(b) expenses of relocating and operating out of temporary facilities during repair;

(c) increased transportation costs from shipping product to and from alternative locations during repair; and

(d) [add other specifics as negotiated].

Exception. This waiver does not apply to claims under the indemnity [loss-payable] clause in section ____. [In the loss-payable clause, add "This loss-payable clause is not limited by the waiver of damages in section ____."]

Acknowledgments. [Not necessary, but avoids foreseeability arguments.] The builder and the manufacturer are aware that:

(a) the plant will be used for offices and the manufacturing of metal widgets;

(b) the plant will contain furniture and equipment for these purposes;

(c) many people will occupy the building in a normal workday, including visitors;

(d) until construction is completed, the manufacturer's operations will continue to be carried out in a less efficient manner in other locations;

(e) if completion is late, the manufacturer will also suffer the expense of extending leases in existing locations or seeking and moving to temporary locations; and

(f) the manufacturer expects that the consolidation and concentration of offices and manufacturing in the new plant will reduce costs and produce efficiencies, thus increasing the manufacturer's profits on the consolidated operations.

- Can the amount of damages be estimated? (Relocation expenses might be; wrongful-death judgments probably can't be.)
- Would damages arise from unique circumstances that the other party may not be aware of?
- Would the parties consider a waiver of damages over a specified dollar amount, perhaps coordinated with insurance limits? Ken Adams strongly advocates the use of dollar caps to limit damages.[6] Should the cap be the same for all kinds of damages?
- Should you coordinate the waiver with applicable insurance? Drafters should, for example, consider (1) whether to apply the waiver only to damages that exceed insurance proceeds and (2) whether to require parties to carry minimum amounts of liability insurance.
- Would exceptions to a broad waiver be appropriate, such as an exception for all third-party claims?
- Should the waiver apply to any contract indemnities? Drafters often overlook this coordination.

As Ken Adams points out, a waiver of damages that the breaching party could not reasonably have foreseen is what some people think you accomplish by waiving consequential damages.[7] But again, a waiver tied to foreseeability really does not waive anything that would be recoverable without the waiver: unforeseeable damages are not recoverable under any circumstances. It also leaves the question of foreseeability open to argument.

You may need more words to address a waiver of specific damages in terms that clients can understand, but the gain in clarity is well worth those words. Addressing the bulleted specific questions beginning on the previous page and continuing at left will prompt the parties to negotiate to achieve specificity and clarity on damage waivers. And isn't that the whole point of good contract drafting? ■

The Contest

There's still time to try your hand at the latest fabulous contest. The deadline is September 22. You'll find it in the August column. Just Google "Plain Language column index."

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ENDNOTES

1. Waivers often include other categories of damages, such as punitive, exemplary, indirect, special, and incidental. This article limits itself to consequential damages, sometimes referred to as special damages. Consequential damages are often contrasted with direct or general damages.
2. Michigan follows the rule of *Hadley v Baxendale*, 156 Eng Rep 145; 9 Exch 341 (1854) (holding that consequential damages will be awarded only if they were within the parties' contemplation when the contract was made). *Kewin v Mass Mut Life Ins Co*, 409 Mich 401; 295 NW2d 50 (1980); *Barker v Underwriters at Lloyd's, London*, 564 F Supp 352 (ED Mich, 1983); *Frank W Lynch & Co v Flex Techs, Inc*, 463 Mich 578, 586; 624 NW2d 180 (2001); *Hajciar v Crawford & Co*, 142 Mich App 632; 369 NW2d 860 (1985).
3. MCL 440.2715. The Uniform Commercial Code also bars recovery of consequential and special damages except as otherwise allowed. Compare UCC § 1-305 (MCL 440.1305) with UCC § 2-715 (MCL 440.2715), UCC § 2A-518 (MCL 440.2968), and UCC § 2A-519 (MCL 440.2969).
4. Lost profits are often cited as the archetype of consequential damages. But this is misleading, since lost profits can be recoverable as direct (nonconsequential) damages if the other party could reasonably foresee that the innocent party would lose profits upon a breach. *Lawrence v Will Darrah & Assoc*, 445 Mich 1; 516 NW2d 43 (1994); *Biotronik AG v Conor Medsystems Ireland, Ltd*, 22 NY3d 799; 11 NE3d 676 (2014); West & Duran, *Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements*, 63 Bus Law 777, 792, 792 n 72 (2008).
5. West explores this ambiguity in West, *Consequential Damages Redux: An Updated Study of the Ubiquitous and Problematic "Excluded Losses" Provision in Private Company Acquisition Agreements*, 70 Bus Law 991–992 (2015).
6. See Ken Adams, Adams on Contract Drafting, *Follow-Up on Consequential Damages* <http://www.adamsdrafting.com/follow-up-on-consequential-damages/> (posted March 2, 2010) (accessed August 13, 2017).
7. Adams, *A Manual of Style for Contract Drafting* (Chicago: ABA, 3d ed, 2013), §§ 13.105–13.214.