
DESIGN PROFESSIONAL CONTRACT RISK ALLOCATION: THE IMPACT OF WAIVERS OF CONSEQUENTIAL DAMAGES AND OTHER LIMITATIONS OF LIABILITIES ON TRADITIONAL OWNER RIGHTS AND REMEDIES

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I. INTRODUCTION AND OVERVIEW

Design professional contracts typically contain provisions that include design responsibilities, inspections of the work, and review of the contractor's payment applications. These provisions are vital to risk allocation and protection of the owner's rights and remedies. With increasing frequency, design professionals seek to reallocate their risks with contract provisions that waive consequential damages, include exclusive remedies, and limit liability. Such provisions can have a significant, and sometimes unexpected, negative impact on traditional owner rights and remedies.

This article will discuss common examples of design professional contract provisions that waive consequential damages, create an exclusive remedy, and limit liability. The article begins with observations of risk allocation principles in the owner-design professional relationship. The historical development, nature, and enforceability of limitation of liability provisions in construction-related contracts will be discussed. This article will illustrate a scenario and analyze the limited case law to emphasize the practical effect, and consequent risks, of such provisions. The focus is from the owner's perspective but with explanation and discussion of the arguments and rationales of design professionals for seeking waivers of consequential damages, creating exclusive remedies, and limiting liability. The goal of this article is to heighten awareness of the growing phenomenon and provide insight and guidance concerning owners' consideration of risk allocation when confronted with these provisions during contract drafting and negotiation.

II. RISK ALLOCATION FUNDAMENTALS

The risks of bad things happening as the result of inadvertent or other improper acts and omissions by the design professional are many. An inadequate design may not be discovered until the structure nears completion, or even later, resulting in extensive and costly demolition and rework. Delay in design, redesign, approving shop drawings, and responding to the contractor's legitimate questions may spawn a contractor claim for delay damages. Ineffective periodic project site visits followed by the design professional's payment certifications to the owner can lead to the owner's overpayment of contract funds and significant loss to the owner.¹

The list of things that can, and do, go wrong is long. The significance of their

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1. By way of example, only, a surety on a bonded project may contend that the owner's overpayment to the contractor releases the surety's obligations under the performance bond, at least to the extent of the overpayment. See *Transamerica Ins. Co. v. Hous. Auth.*, 669 S.W.2d 818, 822 (Tex. Ct. App. 1984) ("It is well settled that a surety on a performance bond is entitled to rely on the architect's Certificate of Completion as the final discharge of its duty on the bond because the architect is the agent or representative of the owner, and his representation is the representation of the owner.").

occurrence is undeniable. *Someone* must, and *someone* will, pay for the resulting loss. However, the questions remain: (a) who *should* bear the loss when bad things happen as the result of the acts and omissions of the design professional; (b) who *can* bear such loss; and (c) who *will* bear such loss?

A. Which party *should* bear the risk of loss?

All construction-related risks, of every kind and in every amount, are allocated to someone, either by contract or by applicable law—no exceptions exist.² If the contract does not expressly, or by legally cognizable inference, allocate each risk among and between the parties, the risk will be allocated by law.³

Absent contract language to the contrary, the law generally allocates risk to the party whose act or omission caused the loss.⁴ The parties consciously may have never contemplated the specific act or omission that led to loss, yet the law provides the framework to allocate the risk of loss.⁵ Embedded in fundamental jurisprudence is the notion that right can be separated from wrong and that the party at fault for causing a loss should compensate the innocent party.⁶ Stated differently, the innocent party ultimately should not suffer the loss caused by the wrongdoer while the latter party suffers no loss.

Thus, in the abstract, the first question posed above in the owner-design professional context will likely be answered objectively by most along the lines just stated: the design professional generally *should* be expected to bear the losses caused by his or her acts and omissions.

B. Which party *can* bear the risk of loss?

The next question is whether, as a practical matter, the design professional *can* effectively shoulder this allocation of risk without limitation. The corollary question that necessarily follows a negative answer to the “*can*” question is whether, as an equally practical matter, the owner is in position to effectively

2. See *Robinson v. United States*, 330 F. Supp. 2d 261, 287 (W.D.N.Y. 2004) (“[T]he common law of torts is, at its foundation, a means of apportioning risks and allocating the burden of loss.” (quoting *Waters v. N.Y. City Hous. Auth.*, 505 N.E.2d 922, 923 (N.Y. 1987))); *United States v. Westlands Water Dist.*, 134 F. Supp. 2d 1111, 1137 (E.D. Cal. 2001) (“[I]f no other method can adequately interpret the contractual provision in question, the court allocates the risk of the unforeseeable loss to the more efficient risk bearer.”); *St. Joseph Hosp. v. Wolff*, 94 S.W.3d 513, 540 (Tex. 2002) (“[T]he general common law notion that one who is in a position to exercise some general control over the situation must exercise it or bear the loss . . .”). See also 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 1.4–1.10 (2d ed. 1990) [hereinafter 1 FARNSWORTH]; 2 E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS § 9.1 (2d ed. 1990) [hereinafter 2 FARNSWORTH]; JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS § 1-1-1-7 (3d ed. 1987).

3. See *supra* note 2 and all sources cited therein.

4. See *supra* note 2 and all sources cited therein.

5. See *supra* note 2 and all sources cited therein. See also ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 200–03 (3d ed. 2000); Ian Ayers & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

6. See *supra* note 2 and all sources cited therein.

shoulder the reallocation of this risk.

Most design professionals do not possess sufficient independent wealth to pay all losses that may be occasioned by their acts or omissions and, without insurance coverage, each project could turn into a “bet the business” risk. However, for some of the same reasons that individuals routinely carry personal liability, automobile, and homeowners’ insurance coverage, design professionals have available professional liability insurance coverage to protect them from significant loss in the event that their acts and omissions cause damage to their project owners. As with personal liability insurance, the premiums will vary with the limits of coverage, deductibles, and risk history.⁷

Accordingly, the design professional *can* effectively accept the allocation of risk for loss without “betting the business” in the process and without seeking a waiver of consequential damages, an unreasonably low cap on such damages, or a limitation of the available remedies. The insurance is routinely available, and the coverage includes consequential damages to the limits of the policy. The cost of the insurance coverage is not unreasonable, especially considering that the cost (i.e., insurance premiums) will be borne by ultimate consumers of design professional services—the owners.

C. Which party *will* bear the risk of loss?

The most important question posed is, in the context presented, to whom *will* the risk of loss be allocated? For a number of compelling reasons (*e.g.*, the design professional is in the best position to control the risk; the party at fault should be responsible; the innocent party should not be made to suffer while the wrongdoer does not; insurance is readily available to cover the risk and eliminate the potential for economic ruin to the design professional), the risk of the owner’s damages arising from the design professional’s acts and omissions *should* and *can* remain where the law otherwise places it—with the design professional. Despite this conclusion, the question remains whether some compelling reason exists to contractually shift the risk of loss to the owner.

Perhaps the most forthright response of the design professional community to the issue is two-fold. The current economics of the design profession require that most design professional firms (1) cut costs wherever possible and (2) maximize profits wherever they can be found. Over time, the elimination, or significant reduction, of liability (whether by waving consequential damages, by limiting the available remedies, by capping the liability, or some combination thereof) may be expected to significantly reduce the cost of professional liability insurance,

7. Professional liability premiums are typically based upon the design professional’s gross billings. The higher the gross billings, the more the premium will be, at least in absolute dollars. In two recent observed instances, the premiums were 1.18% and 1.79% of gross billings for \$1 million and \$3 million limits of coverage, respectively. The professional liability policy routinely covers both direct and consequential damages arising out of the design professional’s acts and omissions. However, it does not cover intentional acts of wrongdoing or fraudulent acts. Information contained in this footnote is based on observations made by the authors throughout their years of legal experience.

resulting in a corresponding increase in profit for the design professional. Moreover, reduction or elimination of risk will better ensure that the design professional's net profits will not be consumed or exceeded by the owner's offsetting claims. This obviously desirable result for the design professional creates a correspondingly undesirable result for the owner, as illustrated in Part III.

III. THE SCENARIO

A. The project.

The new \$50 million multi-use stadium is seventy percent complete. In eight months, the seats will all be filled for the football team's home opener. After that, more football, soccer, lacrosse, and outdoor concerts are scheduled. This project, unlike most, will generate profits for the school.

B. The problem, the investigation, and the fix.

While walking the project site, the owner's project manager notices horizontal cracking in one of the concrete support columns. Upon a closer look, the cracks are apparent in six of the forty support structures. The project is suspended for investigation.

An investigation by structural engineers reveals that the stadium is sinking under its own weight at these six locations. Six support columns must be demolished to the footings, retrofitted, re-poured, and replaced. The remedial design, demolition, and reconstruction will take at least three months. The demolition and repair costs are expected to exceed \$4 million.

C. The fault and the fallout.

The forensic investigations conclusively determine that the footings for the failed structural support columns were not designed for the soil conditions at those locations. The architect had designed the footings and structural support columns, and the architect had inspected and approved the excavation and soil before the contractor poured any concrete. The architect also had certified the contractor's pay applications for this work.

In addition to the increase to the contract price for the repair costs, the contractor asserts that the suspension of the project for the forensic investigation and redesign delayed the scheduled work and caused impact damages. The contractor seeks an additional \$1 million in compensation from the owner, including loss of home office productivity and unabsorbed overhead, all incurred while the project was suspended for investigation and remedial design.

The architect's original design and contract administration fee was six percent of the \$50 million construction cost, or \$3 million. The owner had already paid the architect \$2 million. The architect, a large international firm, asserted that the remedial design fee would be approximately \$100,000. The architect, however, acknowledged fault and offered to provide the remedial design at no cost, with one

condition: the owner's written assurance that the \$1 million balance of the architect's fee would be paid.

The owner's analysis indicates that, in addition to the extra \$4 million in repair costs and the contractor's \$1 million claim, over \$2 million in profits projected to be generated by the stadium will be lost because of the delay. The forensic engineers' investigation cost \$200,000. Additional interest will increase the project cost by over \$800,000. Moreover, the setback will have a chilling effect on the millions of dollars in pledged, but unremitted, private contributions for the project. Time to call the lawyers.

D. The plight of the owner's counsel.

The owner's counsel begins her work by meeting with the construction team members and reviewing the architect's, contractor's, and forensic engineers' relevant correspondence and reports. After gaining an understanding of the issues, counsel reviews the architect's contract, which is the most important document concerning the legal relationship with the owner. The contract will determine whether the owner or the architect assumed the risk for the structural failures that will cost her client over \$8 million.

E. The Architect's Contract.

Counsel's review revealed that the architect's contract was American Institute of Architects (AIA) Document B141-1997, the Standard Form of Agreement Between Owner and Architect (the Architect's Contract). The Architect's Contract contained section 1.3.6 from the standard form, Claims for Consequential Damages: "The Architect and the Owner waive consequential damages for claims, disputes or other matters in question arising out of or relating to this Agreement."⁸

In addition, the architect modified the standard form to include two additional provisions. The first provision, section 2.9.1.1, Exclusive Remedy, states:

In the event that any of the services of the Architect performed under this Agreement are adjudged to fail to meet the standard of ordinary care applicable to the architecture profession in this state, such services shall be deemed "Defective Services." The Architect shall re-perform all such "Defective Services" at the Architect's sole cost and expense, and such re-performance shall be the Owner's sole and exclusive remedy for such "Defective Services."

The second provision, section 2.9.1.2, Limitation of Liability, states:

Subject to Sections 1.3.6 and 2.9.1.1, which shall supersede and prevail, the extent of the Architect's liability to the Owner for any and all claims and damages recoverable under the terms of this Agreement is limited to the fee actually paid by the Owner to the Architect under this

8. *AIA Document B141-1997: Standard Form of Agreement Between Owner and Architect with Standard Form of Architect's Services*, in THE AMERICAN INSTITUTE OF ARCHITECTS, THE ARCHITECT'S HANDBOOK OF PROFESSIONAL PRACTICE § 1.3.6 (13th ed. 2001) [hereinafter AIA Document B141-1997] (included on CD-ROM accompanying the handbook).

Agreement.

Counsel also noted that the Architect's Contract did not (1) contain any detailed design duties or (2) require professional liability insurance.⁹ The owner signed the Architect's Contract without any modifications other than those discussed.

Counsel is troubled and concerned by the waiver of consequential damages, the exclusive remedy, and the limitation of liability in the Architect's Contract. She wonders whether the architect carried professional liability insurance and how much, and whether insurance even matters given these limitations of liability. Why didn't the client obtain counsel's review before signing the contract? Why would any owner agree to include these provisions in any design professional contract? Are such provisions enforceable? If so, what is the effect of these provisions on the client's statutory, common law, and fundamental contract rights to seek over \$8 million in damages from an architect that candidly admits fault? The analytical journey begins.

IV. THE GENESIS AND NATURE OF DAMAGES WAIVERS, EXCLUSIVE REMEDIES,
AND LIMITATIONS OF LIABILITY

A. The UCC made limitations of liability fashionable and generally enforceable.

Contractual limitations of liability have existed for centuries in various forms.¹⁰ These provisions were introduced into construction-related contracts mostly during the last quarter-century, perhaps the result of the adoption and enactment of some version of Article 2 of the Uniform Commercial Code (UCC) in forty-nine states by 1967.¹¹ Each state to adopt the UCC gave imprimatur to such provisions as commercially reasonable in contracts for the sale of goods.¹²

Historically, the courts utilized basic principles of contract law to determine

9. AIA Document B141-1997 contains few express design professional duties but does provide "[t]he Architect shall be responsible for the Architect's negligent acts or omissions, but shall not have control over or charge of and shall not be responsible for acts or omissions of the Contractor, Subcontractors, or their agents or employees, or of any other persons or entities performing portions of the Work." AIA Document B141-1997, *supra* note 8, § 2.6.2.2. AIA Document B141-1997 does not require that the architect carry professional malpractice or errors and omissions insurance.

10. 3 E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.18, at 936 (2d ed. 1998) [*hereinafter* 3 FARNSWORTH] (stating that prior to the "latter part of the seventeenth century," courts enforced "penal bonds" for the "sum fixed in the bond, regardless of the amount of the loss caused"). See *Hart v. Pa. R.R. Co.*, 112 U.S. 331 (1884) (noting a limitation of liability in a contract for carriage of livestock).

11. CALAMARI & PERILLO, *supra* note 2, § 1-7, at 15. Louisiana is the only state that has not enacted some version of Article 2 of the UCC. *Id.*

12. See U.C.C. § 2-719 (2003) (enabling parties to limit or exclude remedies, limit or alter the measure of damages, or limit or exclude consequential damages); 1 FARNSWORTH, *supra* note 2, § 1.9, at 29-32; CALAMARI & PERILLO, *supra* note 2, § 1-7, at 15-17. See also *Lincoln Pulp & Paper Co. v. Dravo Corp.*, 436 F. Supp. 262 (D. Me. 1977).

whether a particular waiver or limitation was enforceable.¹³ Following the widespread adoption of the UCC, the decisions continued to apply fundamental principles of contract law; however, the courts buttressed their decisions by reference to, or adoption of, the rules codified by the UCC.¹⁴ Regardless of whether the courts applied the common law of contracts or the doctrines developed by the UCC, the results concerning enforceability of these provisions were generally consistent.¹⁵

Virtually every jurisdiction to have decided the question permits enforcement of consequential damages waivers, exclusive remedies, and limitations of liability in construction-related contracts.¹⁶ Particularly in the context of sophisticated parties in a commercial setting,¹⁷ the courts generally conclude that so long as the provisions are not (1) unconscionable,¹⁸ (2) against public policy,¹⁹ or (3) prohibited by statute,²⁰ the parties have a right to bargain for their own contractual rights, remedies, and liabilities.²¹

B. The AIA introduced a waiver of consequential damages into standard

13. See 1 FARNSWORTH, *supra* note 2, § 1.10, at 32–37; CALAMARI & PERILLO, *supra* note 2, § 1-7, at 15–17.

14. See *Valhal Corp. v. Sullivan Assocs., Inc.*, 44 F.3d 195 (3d Cir. 1994) (referring to UCC for guidance regarding limitation of liability in an architectural service contract); *Wausau Paper Mills Co. v. Chas. T. Main, Inc.*, 789 F. Supp. 968 (W.D. Wis. 1992) (applying UCC unconscionability principles to the exclusive remedy provision of an engineering services contract); *Lincoln Pulp & Paper Co.*, 436 F. Supp. at 275–78 (concluding that UCC did not control engineering and design contract limitation of liability but analyzing issues with reference to UCC); *Marbro, Inc. v. Borough of Tinton Falls*, 688 A.2d 159 (N.J. Super. Ct. Law Div. 1996) (evaluating limitation of liability clause in an architectural services agreement with reference to the UCC).

15. See *supra* note 14 and all sources cited therein.

16. See *supra* note 14 and all sources cited therein. See also Michael S. Zetlin & Francine M. Chillemi, *Building a Safe Haven: Clauses Imposing Monetary Limits on Designer Liability*, CONSTRUCTION LAW., Jan. 2000, at 5; Lynn R. Axelroth, *Mutual Waiver of Consequential Damages—The Owner's Perspective*, CONSTRUCTION LAWYER, Jan. 1998, at 11.

17. 1 FARNSWORTH, *supra* note 2, § 4.28, at 331–39.

18. See *Hume v. United States*, 132 U.S. 406 (1889); *Civic Ctr. Drive Apartments Ltd. P'ship v. Sw. Bell Video Servs.*, 295 F. Supp. 2d 1091 (N.D. Cal. 2003); *Mistry Prabhudas Manji Eng'g Pvt., Ltd. v. Raytheon Eng'rs & Constructors, Inc.*, 213 F. Supp. 2d 20 (D. Mass. 2002). See also RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. d (1979).

19. See *Valhal Corp.*, 44 F.3d 195; *Marbro, Inc.*, 688 A.2d 159.

20. See *Sear-Brown Group v. Jay Builders, Inc.*, 665 N.Y.S.2d 162 (N.Y. App. Div. 1997) (applying statutory prohibition only “where a party seeks to protect itself from claims for personal injury and physical damage to property,” not to economic losses); *Bohn Heat Transfer v. Gen. Elec. Co.*, 574 N.E.2d 898, 901 (Ill. App. Ct. 1991) (explaining that while “the limit on GE’s liability is rendered invalid to the extent it attempts to protect GE from liability due to its negligence,” the statute stipulates “exemptions from liability for economic losses are not rendered void or unenforceable” (quoting *Long Island Lighting Co. v. IMO Delaval, Inc.*, 668 F. Supp. 237, 244 (S.D.N.Y. 1987))).

21. See *Valhal Corp.*, 44 F.3d at 204 (“It is a reasonable allocation of risk between two sophisticated parties . . .”); *Wausau Paper Mills Co.*, 789 F. Supp. at 975 (stating that waiver of consequential damages “is a by-product of risk allocation”); *Marbro, Inc.*, 688 A.2d at 162 (“A court should ordinarily ‘enforce contracts as made by the parties.’” (citations omitted)).

form contracts.

In 1997, the bona-fide transition of such provisions into construction-related contracts drew industry-wide attention when the AIA introduced a mutual waiver of consequential damages in its standard forms of owner-architect and owner-contractor agreements.²² The AIA's adoption of a mutual waiver of consequential damages in its standard forms of contract was a bellwether event because the AIA forms are the "benchmark" and "most influential documents" in the construction industry.²³ However, relatively little case law exists concerning the interpretation and treatment of consequential damages waivers, exclusive remedies, and limitations of liability provisions in purely construction-related contracts.²⁴

C. Limitations of liability.

Limitations of liability can take many forms and may generally include exclusive remedies and damages waivers.²⁵ Limitations of liability also may provide a specific dollar limit, or "cap," on the exposure of one party for the damages of another.²⁶ Various methodologies are utilized to arrive at a cap. Common approaches including limiting liability to the party's fee, the contract price, available insurance, or some other amount presumptively reflective of the agreeable risk allocation between the parties.²⁷ Liability caps generally are enforceable unless "the cap is so minimal compared with the expected compensation, that the concern for the consequences of a breach is drastically

22. AIA Document B141-1997, *supra* note 8, § 1.3.6; *AIA Document A201-1997: General Conditions of the Contract for Construction*, in THE AMERICAN INSTITUTE OF ARCHITECTS, THE ARCHITECT'S HANDBOOK OF PROFESSIONAL PRACTICE, § 4.3.10 [hereinafter AIA Document A201-1997] (included on CD-ROM accompanying the handbook). The current draft 2007 editions of the architect and contractor agreements retain the mutual waiver of consequential damages. See Axelroth, *supra* note 16.

23. The American Institute of Architects, History of Contract Documents, http://www.aia.org/docs_history (last visited Oct. 20, 2006).

24. The AIA forms of contract contain mandatory arbitration provisions. AIA Document B141-1997, *supra* note 8, § 1.3.5; AIA Document A201-1997, *supra* note 22, § 4.6. Consequently, most of the disputes relating to the AIA waiver of a consequential damages provision can never be substantively evaluated by the courts. *But see Valhal Corp.*, 44 F.3d at 198 (liability cap in architectural firm's proposal); *Wausau Paper Mills Co.*, 789 F. Supp. at 970 (waiver of consequential damages in an engineering services contract); *Marbro, Inc.*, 688 A.2d at 163 (exclusive remedy clause in an architectural services agreement).

25. Zetlin & Chillemi, *supra* note 16.

26. See *Valhal Corp.*, 44 F.3d at 202; *Mistry Prabhudas Manji Eng'g Pvt., Ltd.*, 213 F. Supp. 2d at 25-26; *Sear-Brown Group*, 665 N.Y.S.2d at 163; *Estey v. MacKenzie Eng'g, Inc.*, 927 P.2d 86, 89 (Or. 1996); *Marbro, Inc.*, 688 A.2d at 162-63.

27. See *Valhal Corp.*, 44 F.3d at 198 (liability not to exceed \$50,000 or the fee); *Mistry Prabhudas Manji Eng'g Pvt., Ltd.*, 213 F. Supp. 2d at 22 (liability limited to 10% of amount engineer paid); *Estey*, 927 P.2d 86 (liability limited to "the Contract Sum"). See also Zetlin & Chillemi, *supra* note 16; James D. Weier, Seth D. Lamden & Ric D. Glover, *Preserving Consequential Damages Through Limited Waivers and Insurance Coverage*, CONSTRUCTION LAWYER, Summer 2002 (proposing that consequential damages waivers should be limited to uninsured consequential damages).

minimized.”²⁸

Liability caps typically establish explicit, measurable, bargained-for amounts or limits on one party’s maximum exposure to, and the other party’s maximum recovery of, damages. Liability caps are perhaps the most straightforward form of limitation of liability for an owner to evaluate in the context of risk allocation analysis. An owner, certainly with assistance of competent counsel, should be able to anticipate the project’s major financial risks and evaluate whether the design professional’s maximum monetary contribution for a loss will be sufficient to reasonably offset the risk that the owner is unwilling, or unable, to absorb. In the Scenario, for example, the architect’s exposure to damages is capped at its fee, six percent of the \$50 million project cost, or \$3 million.²⁹ At a minimum, the owner has a definite, hard dollar maximum recovery amount to evaluate against typical losses that might be caused by the architect.

D. Exclusive remedies.

An exclusive remedy is a type of limitation of liability.³⁰ The UCC warranty provisions popularized exclusive remedies by permitting the seller to identify and agree to provide a specific remedy in response to a breach of contract related to the sale of goods.³¹ Exclusive remedies have extended beyond the UCC to contracts where the sale of goods is mixed with services³² and to pure services contracts.³³ The commonality between exclusive remedies is that these provisions recite a specific contracted-for remedy in lieu of other contract, statutory, or common law remedies.³⁴ Typically, exclusive remedies substitute some repair or performance obligation for dollar damages.³⁵

28. *Marbro, Inc.*, 688 A.2d at 162. *See also Valhal Corp.*, 44 F.3d at 204.

29. *See supra* Parts III.C, III.E.

30. *See Wausau Paper Mills Co.*, 789 F. Supp. at 975 (ordering reperformance of engineering services that failed to meet the standard of care); *Bohn Heat Transfer*, 574 N.E.2d at 899 (stating that the “exclusive remedy for defective repair was for GE to re-perform the service, or replace defective parts”); *N.Y. State Elec. & Gas Corp. v. Westinghouse Elec. Corp.*, 564 A.2d 919, 930 (Pa. Super. Ct. 1989) (limiting remedy to repair or replacement); *Koppers Co. v. Inland Steel Co.*, 498 N.E.2d 1247, 1256 (Ind. Ct. App. 1986) (limiting remedy to correction of engineering drawings without charge).

31. U.C.C. § 2-719 (2004).

32. *See Bohn Heat Transfer*, 574 N.E.2d at 901 (limiting the remedy to contractual provisions for breach of contract and breach of implied warranty for services performed for goods sold); *N.Y. State Elec. & Gas Corp.*, 564 A.2d at 924–25 (holding the exclusive remedy for improper performance of services and defective materials was provided in the contract for sale of two turbine generators).

33. *See Wausau Paper Mills Co.*, 789 F. Supp. at 975 (enforcing the exclusive remedy provided in the contract for design engineering services); *Koppers Co.*, 498 N.E.2d at 1251 (recognizing that service contracts can provide limitations on damages, but must have “great particularity and clear, direct and unmistakable language”).

34. *See Wausau Paper Mills Co.*, 789 F. Supp. at 970 (prohibiting consequential damages in any way and providing free repair for faulty service); *Koppers Co.*, 498 N.E.2d at 1249 (limiting damages for breach of contract to free repair).

35. *See Wausau Paper Mills Co.*, 789 F. Supp. at 970 (stating that the client’s exclusive remedies are provided for in the contract); *Koppers Co.*, 498 N.E.2d at 1249 (providing that if the

An exclusive remedy may be difficult for an owner to fully appreciate and evaluate against the panoply of known or potential risks. The primary difficulty manifests in (1) anticipating, in advance, the types or elements of losses likely to result from a breach and (2) evaluating whether the exclusive remedy adequately substitutes for those potential losses. An owner must recognize that a repair or replacement exclusive remedy likely will preclude recovery, or limit the amount, of money damages.³⁶

The difficulty in evaluating an exclusive remedy is exacerbated if the exclusive remedy is in conjunction with another limitation of liability, such as a liability cap.³⁷ An owner and counsel first must clearly understand the basic definition of the common, but legally significant, word “exclusive” placed before the less common yet more legally significant word “remedy.” “Exclusive” means “sole” or “shutting out.”³⁸ “Remedy” means “[t]he means of enforcing a right or preventing or redressing a wrong.”³⁹ The case law suggests that dollar damages become applicable only if the exclusive remedy fails its essential purpose,⁴⁰ has an application clearly separate from the exclusive remedy such as an indemnity provision,⁴¹ or merely establishes a measure of damages.⁴²

In the Scenario, the “exclusive remedy” for “Defective Services,” a contractually defined phrase, is “re-performance.”⁴³ Whether “re-performance of the Defective Services” will be a sufficient “sole” remedy should be dependant upon the value of “re-performance” of the “Defective Services” weighed against potential losses resulting from “Defective Services.” Loss resulting from “Defective Services” will always include the expense of correcting the services (i.e. the redesign), which is covered by the exclusive remedy. Potential losses include the expense to remedy work installed based upon the “Defective Services” (i.e. the installed concrete support columns) and other expenses (i.e. loss of use, lost profits, forensic investigation, etc.), *none* of which are covered by the exclusive remedy.

cost to compete exceeded the unpaid balance of the contract, the architect is liable and may pay the difference).

36. See *Koppers Co.*, 498 N.E.2d at 1251 (noting that the exclusive remedy provision sets “the measure of damages, [but does] not preclude them”).

37. See *Wausau Paper Mills Co.*, 789 F. Supp. at 975 (“The warranty clause makes reperformance plaintiff’s exclusive remedy, with the cost of the remedial services not to exceed an aggregate amount equal to the amount paid by plaintiff under the contract.”).

38. BLACK’S LAW DICTIONARY 352 (5th ed. 1979).

39. BLACK’S LAW DICTIONARY 1320 (8th ed. 2004).

40. See *N.Y. State Elec. & Gas Corp.*, 564 A.2d 919 (stating that the exclusive remedy did not fail in its essential purpose). See also *Wausau Paper Mills Co.*, 789 F. Supp. at 974 (noting that the parties were sophisticated and capable of understanding the contractual provisions limiting liability).

41. See *Valhal Corp.*, 44 F.3d at 202–03 (distinguishing indemnity provisions from other limitations of liability); *Bohn Heat Transfer*, 574 N.E.2d at 901 (arguing that the limit on liability may be invalid to the extent it attempts to protect from liability resulting from negligence).

42. See *Bohn Heat Transfer*, 574 N.E.2d at 901; *Koppers Co.*, 498 N.E.2d at 1251 (stating that Pennsylvania courts have interpreted exclusive remedy provisions as “setting the measure of damages, not as precluding them” (citations omitted)).

43. See *supra* Part III.E.

E. Waivers of consequential damages.

A waiver of consequential damages also is a form of limitation of liability.⁴⁴ Upon a breach of contract,⁴⁵ two types of damages may be recovered: direct, or general, damages; and indirect, or consequential, damages.⁴⁶ Direct damages “follow naturally from the type of wrong complained of” and are “reasonably expected.”⁴⁷ Consequential damages are “[l]osses that do not flow directly and immediately from an injurious act but that result indirectly from the act.”⁴⁸ Thus, waivers of consequential damages are intended to insulate a party from damages that do not “arise naturally or ordinarily from breach of contract” and damages that are not normally “expected to result from breach.” Like other limitations of liability, waivers of consequential damages became popularized by the UCC before evolving into pure services contracts.⁴⁹

Waivers of consequential damages may be very appropriate for various contracts, including pure services contracts. Waivers of consequential damages, however, are unique from liability caps and exclusive remedies. Based on well-developed case law, owners and counsel can obtain helpful guidance on the meaning, effect, and enforceability of liability caps and exclusive remedies.⁵⁰ A distinct and disturbing uniqueness of a waiver of consequential damages in the context of the case law is (1) a lack of clarity and certainty as to the types or elements of losses that are consequential damages; (2) whether certain types or elements of losses are consequential damages may be an issue of fact; and (3) the types or elements of losses that are consequential damages may actually change, depending upon the relationship of the parties.

A common definition of “waiver” is the “intentional or voluntary relinquishment of a *known* right.”⁵¹ The “right” waived is access to consequential damages, whatever are those types or elements of losses.⁵² Case law indicates that consequential damages are sometimes *unknown*, and arguably *unknowable*, until after the loss is sustained and the dispute is adjudicated.⁵³ Thus, the prospect of

44. See Zetlin & Chillemi, *supra* note 16; Axelroth, *supra* note 16.

45. CALAMARI & PERILLO, *supra* note 2, § 14-5, at 595.

46. *Id.* at 593–96.

47. BLACK’S LAW DICTIONARY 417 (8th ed. 2004).

48. *Id.* at 416.

49. U.C.C. § 2-719 (2005) (stating that parties may limit or exclude consequential damages). See also 1 FARNSWORTH, *supra* note 2, § 4.28, at 335–39.

50. See *supra* notes 26–28, 30 and accompanying text.

51. BLACK’S LAW DICTIONARY 1417 (5th ed. 1979) (emphasis added). A subsequent edition of BLACK’S LAW DICTIONARY defines waiver as “[t]he voluntary relinquishment or abandonment — express or implied — of a legal right or advantage.” See BLACK’S LAW DICTIONARY 1611 (8th ed. 2004).

52. *Wausau Paper Mills Co.*, 789 F. Supp. at 975 (“That plaintiff’s losses went beyond what can be remedied by reperformance is a by-product of risk allocation . . .”).

53. *Mead Corp. v. McNally-Pittsburgh Mfg. Corp.*, 654 F.2d 1197 (6th Cir. 1981) (affirming the trial court’s judgment to award damages to defendant construction company because defendant could not demonstrate that the damages awarded were improperly assessed); *Niagara Mohawk Power Corp. v. Stone & Webster Eng’g Corp.*, No. 88-CV-819, 1992 WL 121726 (N.D.N.Y. May 23, 1992) (denying defendant’s motion for summary judgment to dismiss

waiving consequential damages compels the owner to confront the *unknown*, and sometimes the *unknowable*, as a predicate to risk allocation decisions.

V. THE ABYSS OF CONSEQUENTIAL DAMAGES

An owner should ask counsel, “What are consequential damages?” Counsel’s short, truthful answer should be that no one knows what consequential damages are or may be, at least not with predictability or uniformity.⁵⁴ At best, an owner can understand what consequential damages *may* include and that the final answer could remain unknown until a dispute is ultimately resolved. Perhaps because of the tri-partite relationship between an owner, the architect, and the contractor, waivers of consequential damages provisions in design professional contracts, in particular, may present unanticipated, even illogical, problems for owners. Owner’s counsel must realize that the ability to memorize and recite the legal definitions of direct and consequential damages is only the first step toward understanding and advice concerning the practical effect of a waiver of consequential damages.

A. Consequential, or “indirect,” damages compared with direct damages.

The phrase “consequential damages” is used with great frequency in law schools, legal textbooks, and contracts. Often, the phrase “indirect damages” is used as a synonym for consequential damages because courts have sought to distinguish consequential, or indirect, damages from direct, or general, damages.⁵⁵ The need for the distinction finds its genesis in 1854 with the case of *Hadley v. Baxendale*.⁵⁶

In *Hadley*, the court divided contract damages into two categories.⁵⁷ The first category is damages “as may fairly and reasonably be considered . . . arising naturally, i.e., according to the usual course of things, from such breach of contract itself.”⁵⁸ Category one damages are known as general, or direct, damages.⁵⁹ The

all claims for consequential damages on grounds that they are contractually barred); *Long Island Lighting Co. v. Transamerica Delaval, Inc.*, 646 F. Supp. 1442 (S.D.N.Y. 1986) (concluding that whether the parties’ contractual limitation on consequential damages should be given effect is reserved for trial); *Portland Gen. Elec. Co. v. Bechtel Corp.*, Civil No. 79-103, 1980 U.S. Dist. LEXIS 9712 (D. Or. June 4, 1980) (holding that pursuant to the release provision in the agreement between parties, builders were not liable for any consequential damages arising from the shut down of owners’ nuclear power plant); *Am. Elec. Power Co. v. Westinghouse Elec. Corp.*, 418 F. Supp. 435 (S.D.N.Y. 1976) (finding the precise demarcation between direct and consequential damages is a question of fact to be resolved at trial). *But see* Axelroth, *supra* note 16, at 12 (demonstrating that courts often fail to classify damages as compensatory or consequential).

54. Axelroth, *supra* note 16, at 15.

55. *Supervalu Operations, Inc. v. Ctr. Design, Inc.*, 524 S.E.2d 666, 671 (W. Va. 1999) (“For direct damages ‘there is no requirement that the parties must have actually anticipated them because they are a natural consequence of the breach.’” (quoting *Desco Corp. v. Harry W. Trushel Constr. Co.*, 413 S.E.2d 85, 87 (W. Va. 1991))).

56. 156 Eng. Rep. 145 (Ex. Ch. 1854).

57. *Id.* at 151.

58. *Id.*

second category is “such [damages] as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.”⁶⁰ Category two damages are known as consequential, or indirect, damages.⁶¹

A determination of whether certain breach of contract damages are direct or consequential is not harnessed by an exact formula or a bright-line test.⁶² Some categories of damages appear to fit neatly in the consequential damages bucket, but the case law is inconsistent.⁶³ Damages such as lost future profits, loss of use, financing, business and reputation, loss of management or employee productivity, and home office overhead specifically are identified by the AIA in AIA Document A201-1997 as consequential damages.⁶⁴ The AIA’s definition of these categories of consequential damages can be supported by some, but not all, case law;⁶⁵ however, owners must understand that (1) the courts are confused by consequential damages, and (2) the definition of consequential damages may change depending upon the type of loss and the relationship between the parties.

B. An insurmountable problem for owners and counsel lies in defining consequential damages in the shadow of judicial conflict and confusion.

The general rule is that the owner’s measure of damages for breach of contract is the cost of repair or the diminution in value.⁶⁶ Subject to certain exceptions, the principle that the owner’s costs of repair are direct damages if sought against a contractor or an architect is well-accepted and uniform throughout the country and among legal scholars.⁶⁷ In addition to direct damages, the owner may be entitled to recover “consequential damages.”⁶⁸ These general, common law rules appear simple enough, but in application the determination as to whether specific losses are direct damages or consequential damages varies by jurisdiction, judicial philosophy, and interpretation.

59. CALAMARI & PERILLO, *supra* note 2, § 14-5, at 594–95.

60. 156 Eng. Rep. at 151.

61. CALAMARI & PERILLO, *supra* note 2, § 14-5, at 594–95.

62. Axelroth, *supra* note 16, at 11.

63. Compare *Fairfax County Redevelopment & Hous. Auth. v. Hurst & Assocs. Consulting Eng’rs, Inc.*, 343 S.E.2d 294 (Va. 1986) (stating that owner’s extended financing costs are “direct,” not consequential, damages), with *Stamtec, Inc. v. Anson Stamping Co.*, 346 F.3d 651, 658 (6th Cir. 2003) (“[I]nterest costs are consequential damages . . .”), and *Bill v. Thiessen*, 417 N.W.2d 197, No. 87-0056, 1987 WL 29663, at *2 (Wis. Ct. App. Oct. 13, 1987) (“[I]nterest payments are consequential damages because the interest represents the value of the use of money lost . . .” (citations omitted)).

64. AIA Document A201-1997, *supra* note 22, § 4.3.10.

65. *Id.* See also Axelroth, *supra* note 16.

66. CALAMARI & PERILLO, *supra* note 2, § 14-29, at 633.

67. See *id.*; 11 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 1089 (interim ed. 2002); CHARLES T. MCCORMACK, HANDBOOK ON THE LAW OF DAMAGES § 168 (1935); 11 SAMUEL WILLISTON, WILLISTON ON CONTRACTS § 1363 (3rd ed. 1970). See also 2 ROBERT F. CUSHMAN & JAMES J. MYERS, CONSTRUCTION LAW HANDBOOK § 30.01[B][3][b][ii] (1999).

68. CALAMARI & PERILLO, *supra* note 2, § 14-29, at 633–37.

1. The judge does not know—let the jury decide.

The jurisprudential reality is that the technical definitions of, and legal distinctions between, direct and consequential damages breakdown upon application of particular facts. Learned judges cannot easily or consistently demarcate the differences or draw distinction between direct and consequential damages, yielding lack of uniformity and leaving counsel with little guidance or predictability. Some courts have expressly acknowledged the difficulty in differentiating between direct and consequential damages. In *Mead Corp. v. McNalley-Pittsburgh Manufacturing Corp.*,⁶⁹ the court candidly admitted, “the matter . . . is not so simple. We first note the difficulty in drawing a clear distinction between ‘consequential damages’ and damages recoverable under the general remedy provisions”⁷⁰ Other courts have left the issue to the jury.⁷¹ In *Niagara Mohawk Corp. v. Stone & Webster Engineering Corp.*,⁷² the court recited the standard definitions, but abdicated the issue to the fact-finder, stating, “[C]onsequential damages are recoverable only when they are both foreseeable and within the contemplation of the parties at the time the contract was made. Generally, whether the damages are direct or consequential is an issue of fact that must be reserved for trial.”⁷³ Similarly, in *McNally Wellman Co. v. New York State Electric & Gas Corp.*,⁷⁴ the court opined that “ordinarily the precise demarcation between direct damages and incidental or consequential damages is an issue of fact.”⁷⁵

These decisions highlight a fundamental problem with waivers of consequential damages. Counsel’s advice should be based on a degree of reliable predictability, usually based on the case law. Without the reliable predictability of case law guidance as to the elements and types of losses that a jurisdiction considers consequential damages, counsel may wish to consider advising an owner against the waiver of the unknown.

69. *Mead Corp.*, 654 F.2d 1197.

70. *Id.* at 1207. See *Portland Gen. Elec. Co.*, 1980 U.S. Dist. LEXIS 9712, *3 n.3 (“[T]he only issue before the court, however, is whether Bechtel is liable for consequential damages; it is not necessary at this stage to determine the nature of the damages involved in this case”).

71. Axelroth, *supra* note 16 (discussing the difficulty and confusion in attempting to define “consequential damages”).

72. 1992 WL 121726.

73. *Id.* at *28. See *Long Island Lighting Co.*, 646 F. Supp. at 1459 n.30 (“We reserve for trial the question of whether the plaintiff’s claimed damages would be characterized as direct, incidental, or consequential”); *Am. Elec. Power Co.*, 418 F. Supp. at 459 (“[T]he precise demarcation between direct and consequential damages is a question of fact . . .”).

74. 63 F.3d 1188 (2d Cir. 1995). See *Niagara Mohawk Power Corp.*, 1992 WL 121726, *28 (stating “whether damages are direct or consequential is an issue of fact which must be reserved for trial” (citations omitted)).

75. *McNally Wellman Co.*, 63 F.3d. at 1195.

2. Consequential damages and the relationship analysis: claims against the contractor or design-builder versus claims against the design professional.

Some case law suggests that the relationship of the parties may dictate whether certain damages are consequential or direct. The state that has heightened the importance of a relationship analysis, though indirectly, is Virginia because of the one-year statute of limitations for “non-direct” damages.⁷⁶

a. *Claims against the contractor.*

In the seminal Virginia case, *Richmond Redevelopment & Housing Authority v. Laburnum Construction Corp.*,⁷⁷ the owner sued a contractor, and the court distinguished between the owner’s direct and “non-direct” damages.⁷⁸ The owner sought damages from a contractor for a housing unit destroyed by an explosion resulting from a defective gas pipe joint.⁷⁹ The primary issue before the court was whether the state’s one-year statute of limitations for “non-direct damages” barred the owner’s claims for damages caused by the explosion.⁸⁰ The court observed:

In the case under consideration the gravamen of the plaintiff’s claim . . . was that it had been induced to part with its money on account of a breach of warranty Thus *the parting with the money under the alleged circumstances was the direct damage* suffered by plaintiff and *the damage caused by the explosion for which recovery is here sought was an indirect or consequential result of the initial or direct wrong with which the defendant is charged.*⁸¹

The court analyzed the series of events resulting in the explosion:

In order for the damage here complained of to be produced it was necessary, first, that the allegedly defective union break; second, that the gas escaping from the break proceed along the pipeline beneath the building rather than to the surface of the soil; third, the gas be confined under the building rather than escape through the various vents in the walls; and fourth, that the gas be ignited by a flame or spark from some foreign source, thus causing the explosion.⁸²

The court held that “[t]he resultant damage thus caused cannot be classed as direct damage, for had the allegedly faulty joint (the direct damage) not broken, permitting gas to escape, etc., the indirect or consequential damage here sued for would not have occurred.”⁸³

Thus, the owner’s direct damages against the contractor was the “parting with

76. VA. CODE ANN. § 8-24 (1950).

77. 80 S.E.2d 574 (Va. 1954).

78. *Id.* at 576.

79. *Id.* at 576–77.

80. *Id.* at 576–78.

81. *Id.* at 579 (emphasis added).

82. *Id.* at 579.

83. *Id.* at 579–80.

the money” and the “faulty joint.” The explosion was an indirect result of the faulty joint, and the destroyed building was a consequential, or indirect, damage. Presumptively, the owner could recover the cost to repair the faulty joint from the contractor as direct damages.⁸⁴

b. Claims against the design professional.

The *Laburnum* court’s decision is well reasoned and logical, especially considering the chain of events that had to occur to cause the ultimate “explosion.” *Laburnum*, however, involved an owner’s claim against a contractor. Two decades later, the Virginia courts would have opportunities to apply and extend the reasoning and logic of *Laburnum* to claims against design professionals. While the *Laburnum* court concluded that an “explosion” was an indirect event, the irony of the decision is that owner claims against the architect for the costs of repair may be the real *consequential* damage, at least in Virginia.

In *McCloskey & Co. v. Wright*,⁸⁵ the court applied the *Laburnum* reasoning in a case by a builder against an architect. In *McCloskey*, the builder sought roof repair damages allegedly resulting from the architect’s defective design or negligent construction supervision.⁸⁶ As in *Laburnum*, the issue was whether the roof repair costs were “non-direct” damages barred by the statute of limitations.⁸⁷ The federal district court relied on *Laburnum*, finding that “*the leaking roof is at most a consequential damage of what is here alleged to be the negligent act, i.e. faulty design.*”⁸⁸

In *Federal Reserve Bank of Richmond v. Wright*,⁸⁹ the architect had agreed to provide architectural, engineering, and supervisory services for the design and construction of a communications and records center in the Federal Reserve Bank.⁹⁰ The owner sued the architect for costs to correct structural deficiencies resulting from the contractor’s implementation of defective plans.⁹¹ Again, the court analyzed whether the owner’s structural repair costs were “non-direct” damages barred by the statute of limitations.⁹² Citing *Laburnum*, the court observed that “[i]f the action is one for indirect damages, it does not survive and the one year statute applies.”⁹³ The court found, “Plaintiff herein seeks damages in

84. For cases discussing the owner’s measure of damages against a design professional, see *Bus. Men’s Assurance Co. of Am. v. Graham*, 891 S.W.2d 438 (Mo. Ct. App. 1995); *City of Charlotte v. Skidmore, Owings & Merrill*, 407 S.E.2d 571 (N.C. Ct. App. 1991); *Bd. of Educ. of the Hudson City Sch. Dist. v. Sargent, Webster, Crenshaw & Folley*, 539 N.Y.S.2d 814 (N.Y. App. Div. 1989).

85. 363 F. Supp. 223 (E.D. Va. 1973).

86. *Id.* at 225–26, 229–30.

87. *Id.* at 229–30.

88. *Id.* at 230 (emphasis added).

89. 392 F. Supp. 1126 (E.D. Va. 1975) (same defendant as in *McCloskey & Co.*, 363 F. Supp. 223).

90. *Id.* at 1127–28.

91. *Id.* at 1131.

92. *Id.* at 1128–30.

93. *Id.* at 1131.

the amount necessary to *correct the various structural deficiencies which allegedly resulted from defective plans*. Under *Laburnum*, these would *clearly be indirect damages flowing from the primary breach*.⁹⁴ Importantly for owners' awareness, the court emphasized: "*damages arising from the implementation of deficient plans are indirect consequences of such primary breach*."⁹⁵

c. Claims against design-builders.

These cases above illustrate that, as to the design professional under Virginia law, the costs to correct or repair the work resulting from design professional acts or omissions are consequential damages, at least in Virginia. The Virginia rules change with a claim by an owner against a design-builder, where even the owner's "extended financing costs" are direct damages.

In *Roanoke Hospital Ass'n v. Doyle & Russell, Inc.*,⁹⁶ another Virginia case following *Laburnum*, the differences and distinctions become obvious. In *Roanoke Hospital*, a contractor agreed to build a fourteen-story building.⁹⁷ The owner had obtained a letter of commitment on a loan at 6 3/8% interest contingent upon a specific loan closing date.⁹⁸ The owner testified that, when the bids were opened, he told the contractor's representatives that the building must be completed by the date specified in the construction contract or else financial arrangements would have to be redone or rearranged and would cost the owner a higher rate of interest.⁹⁹

The contractor allegedly caused a delay of the construction of the project.¹⁰⁰ The issue before the court was whether the owner was entitled to damages for added interest costs resulting from the delay to the project.¹⁰¹ While the UCC, some case law, and the AIA consider added interest costs consequential damages,¹⁰² the court drew some notable distinctions arising in the owner-contractor relationship:

Here, the damages claimed by the owner involve three types of interest costs: (1) added interest costs (including expenditures on borrowed funds and interest revenue lost on the invested funds) during the construction period arising from the longer term of borrowing necessitated by the contractor's unexcused delay (hereinafter, "extended financing cost"); (2) added interest costs during the construction period attributable to higher interest rates during the extended term (hereinafter, "incremental construction interest cost"); and (3) added

94. *Id.* (emphasis added).

95. *Id.* at 1134 (emphasis added).

96. 214 S.E.2d 155 (Va. 1975).

97. *Id.* at 156-57.

98. *Id.*

99. *Id.*

100. *Id.* at 158.

101. *Id.* at 159-61.

102. See 3 FARNSWORTH, *supra* note 2, § 12.9, at 880-81 & n.3 (regarding UCC and cases cited therein). See also AIA Document A201-1997, *supra* note 22, § 4.3.10.

interest costs for the permanent loan attributable to higher interest rates (hereinafter, “incremental permanent interest costs”).

The owner argues that all three types of interest costs are direct damages and that [the jury] instruction . . . insofar as it classifies the latter two types as consequential damages, was erroneous. The contractor argues that all three types are consequential damages. We agree with the owner and the trial court that the *extended financing costs are direct damages*. Customarily, construction contracts, particularly large contracts, require third-party financing. Ordinarily, delay in completion requires an extension of the term of construction financing. *The interest costs incurred and the interest revenue lost during such an extended term are predictable results of the delay and are, therefore, compensable direct damages.*

We agree with the trial court that the damages resulting from increased interest rates are not direct damages. Increases in the interest rates are not caused by delays in completion of construction contracts. Rather, they are caused by variable pressures . . . affecting supply and demand in the money market. . . . For that reason, increases in interest rates are “special circumstances”, and damages resulting therefrom are consequential and not compensable unless such circumstances were within the contemplation of the parties.¹⁰³

“Extended financing costs” are considered by some respected courts to be consequential damages.¹⁰⁴ AIA A201-1997 specifically includes “financing” as one of the potential losses that the owner waives as a consequential damage.¹⁰⁵ In Virginia, an owner’s “extended financing costs” were determined to be a direct damage against a design-builder because, as the court explained, the *“interest costs incurred and the interest revenue lost during such an extended term are predictable results of the delay.”*¹⁰⁶

Logically, an even more “predictable result” of a defective design is the cost to repair work put in place based on the defective design. Yet, the *Wright* cases

103. *Roanoke Hospital*, 214 S.E.2d at 160–61 (emphasis added). See *Lincoln Pulp & Paper Co.*, 436 F. Supp. 262 (offering no distinction of damages caused by defective design from damages caused by defective construction where defendant was both the designer and the builder); *Wright Schuchart, Inc. v. Cooper Indus., Inc.*, 40 F.3d 427, No. 93-35778, 1994 WL 621889, at *3 (9th Cir. Nov. 8, 1994) (“We agree with [the owner], however, that any costs incurred by directly contributing to the repair of defective . . . equipment are recoverable as direct damages” against the design-builder). See also John P. Ludington, Annotation, *Modern Status of Rule as to Whether Cost of Correction or Difference in Value of Structures is Proper Measure of Damages for Breach of Construction Contract*, 41 A.L.R. 4TH 131, § 4 & n.19 (1985) (concerning damages for breach of construction contract and citing *Roanoke Hospital* for a discussion of the difference between direct and consequential damages).

104. See, e.g., *Stamtec, Inc.*, 346 F.3d at 658 (stating that interest costs are consequential damages); *Bill v. Thiessen*, 1987 WL 29663, at *2 (“[I]nterest payments are consequential damages because the interest represents the value of the use of money lost” (citations omitted)).

105. AIA Document A201-1997, *supra* note 22, § 4.3.10.

106. *Roanoke Hospital*, 214 S.E.2d at 161 (emphasis added).

indicate that such logic is *wrong*.¹⁰⁷ The conclusion yields that the owner's damages against the contractor or design-builder may be direct when the same damages against the architect may be consequential, notwithstanding well-established rules regarding the *measure* of damages.¹⁰⁸

- C. Contractual waivers of consequential damages may yield inconsistencies between the parties' respective waived claims—the AIA's "mutual" waivers of consequential damages.

The confusion, uncertainty, and inconsistency of the case law suggests that if the parties choose to waive consequential damages, the waiver should be based upon a well-drafted contract provision that establishes understood and "known" definitions that provide a certain framework for risk allocation. The AIA contracts provide a backdrop for analysis.

The AIA did not define or list types of "consequential damages" that are waived in the standard form of owner-architect agreement, perhaps satisfied with the declaration that the waiver is "mutual."¹⁰⁹ The AIA's "mutual waiver," however, may not be completely "mutual."¹¹⁰

An owner will suffer at least two elements of damages if work is installed based on defective plans: (1) the cost of the redesign and (2) the cost to repair or replace the defective, in-place, work.¹¹¹ As illustrated by the Scenario, the owner's losses also may include lost profits resulting from the delayed opening of the stadium, and other possible consequential damages (i.e., interest costs, forensic engineering costs).¹¹² If the owner's lost profits are consequential damages, the owner has waived this element of damages under all circumstances.¹¹³

107. See *supra* notes 85–95 and accompanying text.

108. See *supra* note 84 and accompanying text.

109. AIA Document B141-1997, *supra* note 8, § 1.3.6.

110. Axelroth, *supra* note 16. See William R. Wildman, *Making AIA Contracts Work for You*, RETAIL TRAFFIC, May 1, 2000, http://www.retailtrafficmag.com/mag/retail_making_aia_contracts/index.html ("[T]he owner gives up just about every claim [it] might have against the contractor or architect if the project is delayed, while the contractor and the architect give up very little in return.")

111. See *supra* notes 85–95 and accompanying text.

112. *Interstate Brands Corp. v. Lily Transp. Corp.*, 256 F. Supp. 2d 58, 62–63 (D. Mass. 2003) (determining jury had already been instructed to award interest); *Hale v. Ruff*, No. CA98-1373, 1999 WL 436281, at *4 (Ark. Ct. App. June 23, 1999) (awarding damages for lost profits); *Perini Corp. v. Grete Bay Hotel & Casino, Inc.*, 610 A.2d 364, 373–74 (N.J. 1992) (upholding damages for lost profits based on evidence that damages were reasonably foreseeable); *Naegeli Transp., v. Gulf Electroquip, Inc.*, 853 S.W.2d 737, 739 (Tex. Ct. App. 1993) (finding that party pleading lost profits as an element of consequential damages was not in error); *R.K. Chevrolet, Inc. v. Hayden*, 480 S.E.2d 477, 481 (Va. 1997) (allowing expert testimony to present his opinion as to the amount of damage suffered). See *Calbag Metals Co. v. Guy F. Atkinson Co.*, 770 P.2d 600, 602 (Or. Ct. App. 1989) (stating that lost profits are consequential damages under the UCC). *But see* *Imaging Sys. Int'l, Inc. v. Magnetic Resonance Plus, Inc.*, 490 S.E.2d 124, 127 (Ga. Ct. App. 1997) ("[T]here are two types of lost profits: (1) lost profits which are direct damages and represent the benefit of the bargain . . . and (2) lost profits which are indirect or consequential damages . . .").

113. See *Perini Corp.*, 610 A.2d at 373–74 (stating that owner's lost profits are consequential

The architect's lost profits, however, are not waived under some circumstances. Assume that the owner in the Scenario, having lost all confidence in the architect, wrongfully refuses to pay the balance of the architect's fee, \$1 million. The architect then terminates the contract and seeks damages from the owner.¹¹⁴ The architect's sole loss from an owner's alleged breach is usually the balance of profit remaining in its fee, or net lost profit.¹¹⁵ To the extent that the architect's lost profits (like the owner's lost profits) may be consequential damages,¹¹⁶ the AIA exempts the architect's lost profit from the consequential damages waiver under different sections:

§ 1.3.8.6 “[T]he Architect shall be compensated for services performed prior to termination, together with Reimbursable Expenses then due and all Termination Expenses as defined in Section 1.3.8.7.”¹¹⁷

§ 1.3.8.7 “Termination Expenses are in addition to compensation for the services of the Agreement and include expenses directly attributable to termination for which the Architect is not otherwise compensated, *plus an amount for the Architect's anticipated profit on the value of the*

damages and may be recovered in an action for breach of contract). *See, e.g., Stamtec, Inc.*, 346 F.3d at 658 (“interest costs are consequential damages”); *Bill v. Thiessen*, 1987 WL 29663, at *2 (“[I]nterest payments are consequential damages because the interest represents the value of the use of money lost . . .” (citations omitted)); *Old River Terminal Co-Op v. Davco Corp. of Tenn.*, 431 So.2d 1068, 1071 (La. Ct. App. 1983) (stating that fees of consulting engineers are consequential damages).

114. The Architect's Contract contemplates that the architect may perform “Defective Services” and provides a remedy of re-performance. *See supra* Part II.E. Thus, the architect may perform “Defective Services” without breaching the contract. If the architect is willing to abide by the contract and provide the agreed remedy of re-performance, the owner has no argument that the architect breached the contract. The owner's non-payment of the balance of funds owed to the architect, however, would constitute a breach entitling the architect to terminate the contract. AIA Document B141-1997, *supra* note 8, § 1.3.8.1.

115. *S. Land, Timber & Pulp Corp. v. Davis & Floyd Eng'rs Inc.*, 135 S.E.2d 454, 459 (Ga. Ct. App. 1964); *Pallardy v. Link's Landing, Inc.*, 536 S.W.2d 512, 515 (Mo. Ct. App. 1976); *Gunter Hotel of San Antonio, Inc. v. Buck*, 775 S.W.2d 689, 697 (Tex. Ct. App. 1989); *John Call Eng'g, Inc. v. Manti City Corp.*, 795 P.2d 678, 691 (Utah Ct. App. 1990). *See* 3 FARNSWORTH, *supra* note 10, § 12.9–12.10, at 880–91. *See also* AIA Document B141-1997, *supra* note 8, §§ 1.3.6, 1.3.8.6 & 1.3.8.7.

116. As emphasized in this Article, a major problem with waivers of consequential damages is the lack of uniformity in judicial interpretation. Some cases suggest that all lost profits are consequential damages, while others draw distinctions between different types of lost profits: “(1) lost profits which are direct damages and represent the benefit of the bargain . . . and (2) lost profits which are indirect or consequential damages.” *Imaging Systems Int'l, Inc.*, 490 S.E.2d at 127 (five judges concurred in the decision with two judges dissenting, reflecting a lack of unanimity of judicial interpretation within a single court). *See supra* note 112 and all sources cited therein. The definitional distinctions of the court in *Imaging Systems* are the most logical in a benefit of the bargain analysis to breach of contract damages; however, if “lost profits . . . are direct damages and represent the benefit of the bargain,” *Imaging Systems Int'l, Inc.*, 490 S.E.2d at 127, then the AIA need not include lost profits separately as an element of the architect's recoverable damage since those damages would not be covered by the waiver. Perhaps wisely for its constituency, the AIA may have effectively withdrawn the issue of the architect's lost profits (under certain circumstances) from judicial interpretation.

117. AIA Document B141-1997, *supra* note 8, § 1.3.8.6.

services not performed by the Architect."¹¹⁸

The AIA owner-architect agreement, therefore, clearly obligates the owner to pay the architect's lost profits under certain circumstances while the owner may waive lost profits under all circumstances.¹¹⁹

The AIA did define *some* "consequential damages" of the "mutual" waiver in the owner-contractor contract.¹²⁰ The definitions serve to emphasize and make clear that the types of losses waived by the owner and the contractor are not the same, or mutual:

§ 4.3.10 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 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.¹²¹

While § 4.3.10 may not list every type or element of consequential damage waived, a comparison of the items listed, and the lack of "mutuality," is striking.

The consequential damages that the owner waives specifically include "rental expenses, . . . losses of use, income, profit, . . . and for loss of management or employee productivity or of the services of such persons."¹²² By comparison, the contractor does not expressly waive any of those items except anticipated lost profits that do not arise "directly from the Work."¹²³ As in the owner-architect contract, the owner waives all lost profits as consequential damages, but the contractor, under a separate section of AIA A201-1997, may recover its lost profits under the contract in the event of a termination for convenience.¹²⁴ In other words, the contractor *is not expressly* precluded from recovering items that the owner *is*

118. *Id.* § 1.3.8.7 (emphasis added).

119. *Id.* See *supra* note 112 and all sources cited therein.

120. AIA Document A201-1997, *supra* note 22, § 4.3.10.

121. *Id.* (emphasis added).

122. *Id.* § 4.3.10.1.

123. *Id.* § 4.3.10.1.

124. *Id.* § 14.4.3.

expressly precluded from recovering, such as “rental expenses, . . . losses of use, income, profit, . . . and for loss of management or employee productivity or of the services of such persons.”¹²⁵

The AIA provides that the “mutual waiver” does not “preclude an award of *liquidated direct damages* [to the owner], when applicable, in accordance with the requirements of the Contract Documents.”¹²⁶ “Liquidated damages” are typically agreed to as an amount that will compensate the owner for an unexcused contractor delay because actual damages are difficult to prove.¹²⁷ Liquidated damages are generally considered a contractually agreed upon replacement for damages that might otherwise be considered “consequential,” like extended financing, lost profits, and loss of use.¹²⁸ The AIA’s use of the phrase “liquidated *direct* damages” therefore brings more uncertainty to the owner for fear that the “liquidated *direct* damages” are a subset of “liquidated damages” comprised of some undefined “direct” damages, if anything at all.¹²⁹

The lesson for owners is that even contractual definitions and persuasive words like “mutual” may be a trap for the unwary. The “mutuality” of the waiver is not nearly as important as the specific items or elements of potential losses that are actually waived. One cannot assume that the word “mutual” automatically means that the consequential damages of the owner, the architect, or the contractor are the same types or elements of losses.

VI. RATIONALES FOR INCLUDING WAIVERS OF CONSEQUENTIAL DAMAGES, EXCLUSIVE REMEDIES, AND LIMITATIONS OF LIABILITY IN CONSTRUCTION-RELATED CONTRACTS

Several rationales, or arguments, have been advanced to justify the various limitations of liability. Some rationales are logical and persuasive. In the context of a high value construction project, the negotiated agreement should always account for which party is best positioned to minimize or eliminate, and therefore bear, the risk.

A. Rationale number one: The waiver of consequential damages is mutual.

One rationale is reflected in the AIA standard form of architect-owner contract specifically for waiver of consequential damages.¹³⁰ As discussed above, the AIA

125. *Id.* §§ 4.3.10.1, 14.4.3. See *City of Milford v. Coppola Constr. Co.*, 891 A.2d 31, 39 (Conn. App. Ct. 2006) (stating that contractor’s costs of “idle equipment” and “stockpiled material” constitute direct damages under AIA Document A201 general conditions, not precluded by mutual waiver of consequential damages).

126. AIA Document A201-1997, *supra* note 22, § 4.3.10 (emphasis added).

127. See 3 FARNSWORTH, *supra* note 10, § 12.9–12.18, at 935–45. See also 2 CUSHMAN & MYERS, *supra* note 67, § 32.01–32.06 (many cases cited therein).

128. 2 CUSHMAN & MYERS, *supra* note 67, § 32.06.

129. Axelroth, *supra* note 16, at 15. The current draft of AIA Document A201-2007, scheduled for publication in 2007, eliminates the word “direct,” leaving only the phrase “direct damages.” The new draft of AIA Document A201-2007 will not be published until 2007.

130. AIA Document B141-1997, *supra* note 8, § 1.3.6. See also AIA Document A201-1997,

introduced the concept as a “mutual waiver.”¹³¹ This “mutual waiver” is contended to be a *quid pro quo* and, as such, inherently fair. While “fairness” is subjective and debatable, the AIA documents simply do not reflect a complete “mutual” waiver of consequential damages. Mutuality connotes fairness and equality of treatment or result. The only consequential damages of significance that are waived are those that are sustained, and waived, by the owner.¹³² The resulting benefit to the architect is undeniable. The *quid pro quo* received in return by the owner cannot be found.

The same lack of mutuality can be found in contract clauses that cap liability or limit the owner’s remedy for loss to the design professional’s re-performance of its defective service without further cost to the owner. While ultimately not as serious, the re-performance at no cost remedy is somewhat analogous to the surgeon’s offer to remove the diseased lung at no additional cost after erroneously removing the healthy one. Little mutuality is readily apparent.

A real “mutual” waiver of consequential damages is achievable. If achieved, the question remains: What types or elements of losses are consequential damages? A thorough listing of the specific types or elements of losses that are consequential damages may militate toward the clarity and predictability required for a true “knowing and voluntary” waiver.¹³³ Absent such definitional clarity, real “mutuality” cannot be achieved, and the right to recover potential losses that might be consequential damages cannot not be waived without accepting some risk of the unknown.

B. Rationale number two: A lower cost project.

A second rationale applicable to all limitations of liability is that the owner will receive the benefit of a lower fee from the design professional.¹³⁴ The theory is that an elimination or reduction of risk by capping damages, agreeing to a remedy, or waiving consequential damages permits the design professional to factor out of the design fee some, or all, risk of financial exposure.¹³⁵ With risk of financial exposure reduced or eliminated, the owner gets the project at a lower fee and lower overall cost.¹³⁶

The theory supporting this rationale has been embraced in New York for purposes of limiting liability for “injuries to person or property caused by or resulting from . . . negligence.”¹³⁷ Under a specific statute, one may limit liability for negligence if “there is a voluntary choice of obtaining full or limited liability by

supra note 22, § 4.3.10.

131. See AIA Document B141-1997, *supra* note 8, § 1.3.6.

132. See *supra* note 110 and accompanying text.

133. See *supra* note 51 and accompanying text.

134. Zetlin & Chillemi, *supra* note 16. See Weier, Lamden & Glover, *supra* note 27 (proposing that consequential damages waivers should be limited to uninsured consequential damages).

135. See *supra* note 134 and all sources cited therein.

136. See *supra* note 134 and all sources cited therein.

137. N.Y. GEN. OBLIG. LAW § 5-323 (McKinney 1989).

paying under a graduated scale of rates proportioned to the responsibility in . . . service rendered.”¹³⁸ The New York statute requires that “[a]n option must be offered to the other party to pay an increased amount for the services rendered, in order to receive the increased coverage for . . . negligence” for a valid limitation of liability.¹³⁹ Absent such “option,” the limitation of liability is void as an impermissible “exemption” from liability.¹⁴⁰ Importantly, the New York statute prohibits limitations of liability only as to negligence, not for economic losses for breach of contract or warranty.¹⁴¹

The New York requirement of “a graduated scale of rates proportioned to the responsibility” is critical to support this rationale.¹⁴² Without a rate comparison, the cost savings received by the owner in exchange for increased risk assumption cannot be evaluated critically. Accordingly, an owner confronted with the rationale that a limitation of liability will reduce the design professional’s fee should demand comparison pricing and, preferably, comparison pricing from multiple competitors for the same services. Only with an actual pricing analysis can an owner truly determine whether the fee is lower for the reduced risk and whether the owner would prefer to pay less, or more, to allocate the risk differently.

C. Rationale number three: The small fee, or profit margin, does not support the risk.

A third rationale is that the relatively low design fee does not justify the design professional’s assumption of significant risk for the project.¹⁴³ In the Scenario, the architect’s fee is only \$3 million, including overhead, while the overall project cost is \$50 million. Design professionals contend that the profit margins are so small that it would be incongruent for them to assume comparative exponential risk. In sum, the design professionals’ position is that it will not bet the design firm against the risks of the project.

138. *Melodee Lane Lingerie Co. v. Am. Dist. Tel. Co.*, 218 N.E.2d 661, 667 (N.Y. 1966). See *Bohn Heat Transfer*, 574 N.E.2d at 901 (“[T]he limit on GE’s liability is rendered invalid to the extent it attempts to protect GE from liability due to its negligence” however, “[e]xemptions from liability for economic losses are not rendered void or unenforceable . . .”).

139. *Bohn Heat Transfer*, 574 N.E.2d at 901.

140. *Id.*

141. *Id.* See *Sear-Brown Group*, 665 N.Y.S.2d at 163 (N.Y. App. Div. 1997) (stating that prohibition only applies “where a party seeks to protect itself from claims for personal injury and physical damage to property,” not to economic losses).

142. New York law does not apply this standard to limitations of liability for economic losses resulting from a breach of contract. The reasoning, however, applies equally that “[a]n option [could] be offered to the other party to pay an increased amount for the services rendered in order to receive the increased coverage for” a breach of contract. *Melodee Lane Lingerie Co.*, 218 N.E.2d at 667; *Bohn Heat Transfer*, 574 N.E.2d at 901. This standard reflects a baseline against which an owner may evaluate the reallocation of risk, and, if established, emphasizes that the limitation of liability is, in fact, part of the negotiated bargain.

143. *Zetlin & Chillemi*, *supra* note 16. See *Weier, Lamden & Glover*, *supra* note 27 (proposing that consequential damages waivers should be limited to uninsured consequential damages).

An owner entertaining this rationale has cause for alarm. If an owner could self-perform the design and construction of its own structure, the owner would assume all of the risk. Owners, generally, cannot design and build. Owners bring one fundamental asset to the table: the money to pay professionals to deliver the project. Thus, the owner engages a “professional” designer and contractor to provide the deliverables of design and construction of the structure. Likewise, without the owner’s need for a project and the money to pay for its delivery, design professionals and contractors would avoid all risk other than bankruptcy for lack of work to generate a fee.

Most states’ laws identify architects and engineers as “professionals.”¹⁴⁴ A “professional” is defined as “[a] person who belongs to a learned profession or whose occupation requires a high level of training or proficiency.”¹⁴⁵ Design professionals hold themselves out as reliable, dependable, knowledgeable, and experienced—the right fit for the project. Owners must, and do, rely on the design professional’s “high level of training or proficiency” to complete tasks that the owner is unable to self-perform, but for which the owner is willing to pay. Thus, an owner is justifiably concerned when a design professional’s marketing presentation represents superior qualifications to service the project but contract negotiations indicate the lack of willingness to accept ultimate responsibility for the compensated professional task. If a design professional is reluctant to place his or her financial resources at risk against the project, an owner should consider whether to place its financial resources at risk while utilizing an architect that is unwilling to accept ultimate responsibility.

D. Rationale number four: The insurance excuses.

A fourth rationale, or argument, is that the design professional (1) cannot obtain insurance for some risks, or (2) does not have, or cannot afford, insurance to cover some risks. Design professionals often take the position that their insurer “requires” a waiver of consequential damages from the owner.

First, an owner should exercise great caution before engaging a design professional that does not maintain professional liability insurance with limits of coverage adequate for the relative significance of the project. Second, no case law has been found to support the position that professional liability coverage will not, or does not, cover consequential damages. Of course, insurers might support, and even encourage, the rationale to avoid exposure to consequential damages.¹⁴⁶ An owner’s skepticism is encouraged. An owner confronted by this rationale should demand that a copy of the policy, or the applicable provisions or exclusions, be produced for counsel’s review.

144. See, e.g., GA. CODE ANN. § 43-4-1-43-4-37 (2006).

145. BLACK’S LAW DICTIONARY 1246 (8th ed. 2004).

146. See J. KENT HOLLAND JR. & CATHA PAVLOFF, INTERNATIONAL RISK MANAGEMENT INSTITUTE, INC., RISK MANAGEMENT AND INSURANCE FOR DESIGN PROFESSIONALS (2003), <http://www.irmi.com/Conferences/Crc/Handouts/Crc23/Workshops/RmAndInsuranceForDesignProfessionals.pdf> (proposing that design professionals seek limitations of liability in contracts with owners, including proposed language for waiver of consequential damages).

E. Rationale number five: Inability to compete.

Large design professional firms argue that they cannot be competitive without one or more limitations of liability. The reason stated is that smaller design firms are not really at risk because they do not have significant financial resources or deep pockets. Thus, the argument goes, the owner will not waste its money seeking damages against small firms because the owner knows a judgment cannot be collected. Larger firms, on the other hand, actually become exposed to a higher risk because they may have assets or financial resources to satisfy claims or judgments.

A diligent owner requiring that the design professional obtain and maintain professional liability insurance appropriate to cover the project's design services' risks should not be persuaded by this rationale. A large design firm becomes large by success, results, and profits. A small firm may be small for reasons having nothing to do with success, results, and profits. Either, and both, should be able to obtain adequate professional liability insurance to satisfy the owner's reasonable needs for risk allocation. The owner must be willing to pay, as part of the fee or otherwise,¹⁴⁷ for adequate professional liability insurance coverage. If so, this rationale has no validity in the risk allocation calculus. If not, the owner should receive a tangible benefit of a verifiable lower fee reflective of professional liability insurance cost savings. In exchange for the verifiable lower cost service, the owner is simply electing to assume the reallocated risk.

VII. ANALYSIS OF THE SCENARIO, THE LAW, AND THE OWNER'S TRADITIONAL RIGHTS AND REMEDIES

A. The owner.

1. The owner's damages.

The owner's potential damages are: (1) the extra \$4 million in remedial cost; (2) over \$2 million in lost future profits; (3) \$200,000 for the forensic engineers' investigation; (4) over \$800,000 in financing costs; (5) \$1 million for the contractor's delay claims; and (6) an unknown amount in private contributions pledged to the project. The owner's damages may exceed \$8 million.

2. The owner's traditional rights and remedies.

Neither the owner nor the contractor caused, or contributed to, the project's

147. AIA Document B141-1997 contemplates that the owner shall reimburse the architect for certain "Reimbursable Expenses" which "are in addition to compensation for the Architect's services and include expenses incurred by the Architect and Architect's employees and consultants directly related to the Project," specifically listing the "expense of professional liability insurance dedicated exclusively to this Project or the expense of additional insurance coverage or limits requested by the Owner in excess of that normally carried by the Architect and the Architect's consultants." AIA Document B141-1997, *supra* note 8, §§ 1.3.9.2, 1.3.9.2.6.

structural failures. The project's structural failures and resulting losses are traced solely to the acts or omissions of the architect. All of the owner's damages flow, directly or indirectly, from the acts or omissions of the architect.

The owner has a strong case that the architect breached the contract or negligently failed to meet the professional standard of skill and care, or both.¹⁴⁸ Absent the contractual waiver of consequential damages, exclusive remedy, and limitation of liability, the owner could seek all of its damages from the architect.¹⁴⁹ Unhampered by limitations of liability, the owner has access to a full complement of contractual, tort, and perhaps other, remedies recognized and supported by the state's laws. The owner would have the right to seek all of its \$8 million-plus in damages. The owner's greatest contractual hurdle is to prove its damages and show that all of the damages were "foreseeable" under the *Hadley* rule.¹⁵⁰ The owner could offer its evidence and rest relatively assured of a substantial award and judgment against the architect.

The owner would enjoy a high likelihood of a prompt settlement with the architect, especially if the architect is insured. However, an architect's maintenance of insurance coverage with limits sufficient to cover \$8 million may be unusual unless the owner has the foresight to require, and pay for, higher limits of coverage. Without sufficient insurance coverage, an owner must rely upon the architect's financial ability to satisfy any shortfall between coverage limits and damages. An architect likely will part with its own money much more reluctantly than with insurance proceeds. This realization highlights that the owner must factor into its risk allocation analysis adequate insurance requirements; else, the value of traditional rights and remedies may be limited even without contractual limitations of liability.

3. The impact of the waiver of consequential damages, exclusive remedy, and limitation of liability on the owner's traditional rights and remedies.

- a. *The mutual waiver of consequential damages.*

The owner has waived *all* of its consequential damages. The question then becomes: Which of the owner's losses are consequential damages? The cases indicate that the answer will depend on the law in that particular jurisdiction. In the Scenario, the owner would be fortunate to benefit from a jurisdiction where consequential damages are a question of fact—owner's counsel could avoid summary judgment and argue to the fact finder that all of the owner's damages are direct. While the ultimate outcome may remain unknown, the value of having the argument should enhance the settlement value prior to award and judgment.

148. See *supra* note 9 and accompanying text.

149. *Bus. Men's Assurance Co.*, 891 S.W.2d 438; *Brushton-Moira Cent. Sch. Dist. v. Fred H. Thomas Assoc.*, 692 N.E.2d 551 (N.Y. 1998); *Sargent, Webster, Crenshaw & Folley*, 539 N.Y.S.2d 814 (N.Y. App. Div. 1989); *Skidmore, Owings & Merrill*, 407 S.E.2d 571. See CALAMARI & PERILLO, *supra* note 2, § 14-29, at 633-39.

150. See *supra* notes 56-60 and accompanying text.

Aside from jurisdictions that leave the issue of consequential damages to the fact-finder, many of the owner's losses are traditionally considered consequential damages. The \$2 million in *lost future profits* because use of the stadium will be delayed are losses that are considered to be consequential damages in some jurisdictions.¹⁵¹ Likewise, the \$800,000 incurred because of increased *interest rates* resulting from the delay is a consequential damage in some jurisdictions.¹⁵² The \$200,000 cost of the forensic engineers also may be a consequential damage.¹⁵³

The contractor's delay claim is comprised of unabsorbed home office overhead and loss of productivity, both of which likely are consequential damages. The unabsorbed home office overhead and loss of productivity parts of a claim are examples of consequential damages between the owner and the contractor as defined in the AIA A201-1997 General Conditions.¹⁵⁴ If these claims are consequential damages between the owner and the contractor, then logic suggests that these same losses are also consequential damages when passed from the owner to the architect. Finally, the impact of lost private contributions, even if capable of measurement, are likely to be consequential damages.

The extra \$4 million in remedial costs are certainly foreseeable consequences of the defective design. Most owners, their counsel, and the courts would reason that but for the defective design, all of the remedial costs would have been avoided. The textbook and case law definitions of direct and indirect damages seem to support such a conclusion. The general rules indicate that the owner's measure of direct damages may be the cost of repair. At the time of negotiating the Architect's Contract, the assumption and conclusion might follow that the costs necessary to repair and replace elements of the project damaged because of a defective design would clearly be direct, not consequential, damages.

As a matter of practice and reality, however, the reasoning and analysis of the Virginia cases is strikingly contrary. Under *Laburnum* and the *Wright* cases, the \$4 million remedial costs would "*clearly be indirect damages flowing from the primary breach*,"¹⁵⁵ because "*damages arising from the implementation of deficient plans are indirect consequences of such primary breach*."¹⁵⁶ In fact, the project owner's only direct damages would be the fee that the owner had paid to the architect for the design, at most only \$2 million and perhaps only the portion thereof directly attributable to defective structural support design. Moreover, if the jurisdictional rule is that consequential damages are a question of fact, then the

151. *Perini Corp.*, 610 A.2d at 373–75 (stating that lost profits are consequential damages).

152. *Stamtec, Inc.*, 346 F.3d at 658 (“[I]nterest costs are consequential damages”); *Bill v. Thiessen*, 1987 WL 29663, at *2 (“[I]nterest payments are consequential damages because the interest represents the value of the use of money lost” (citations omitted)).

153. *Old River Terminal Co-Op*, 431 So.2d 1068 (stating that fees of consulting engineers are consequential damages).

154. See AIA Document A201-1997, *supra* note 22.

155. *Wright*, 392 F. Supp. at 1131 (emphasis added). See also *Richmond Redevelopment & Housing Auth. v. Laburnum Constr. Corp.*, 80 S.E.2d 574 (Va. 1954).

156. *Wright*, 392 F. Supp. at 1134 (emphasis added). See also *Laburnum Constr. Corp.*, 80 S.E.2d 574.

architect may enjoy the option of arguing that even these costs of repair are consequential damages.

b. The limitation of liability provision.

The owner's counsel reasons that the waiver of consequential damages only applies to a claim for breach of contract. Thus, a tort claim for professional negligence, or malpractice, will circumvent the waiver. While clever, that idea encounters at least three impediments. First, the state's economic loss rule may prohibit recovery for purely economic losses under a tort theory.¹⁵⁷ Second, even if counsel can navigate around the economic loss rule, the Architect's Contract provides "the extent of the Architect's liability to the Owner for any and all claims and damages recoverable under the terms of this Agreement is limited to the fee *actually* paid by the Owner to the Architect under this Agreement."¹⁵⁸ The owner has only paid the architect \$2 million of the \$3 million design fee. The liability cap, therefore, would limit to no more than \$2 million the damages that the owner could obtain from the architect. The owner may have a \$6 million shortfall. The good news is that the owner is still holding the \$1 million design fee balance, but the architect has sought written assurance that the owner will pay the balance in exchange for a free remedial design. The bad news is the third impediment: the owner's tort claim for professional negligence may be supplanted by the exclusive remedy.

c. The exclusive remedy provision.

The Architect's Contract provided for a "sole and exclusive remedy." The architect is required only to re-perform its defective services but only if the services "are adjudged to fail to meet the standard of ordinary care applicable to the architecture profession."¹⁵⁹ The reference to "the standard of ordinary care" suggests that this exclusive remedy is applicable to a tort claim for professional negligence, not a breach of contract claim. Moreover, before the remedy "kicks in" the architect's services must be "adjudged" to be defective. If a formal "adjudication" is required, the owner may have to sue, or arbitrate against, the architect before the remedy is realized. Perhaps the architect's acknowledgement of fault is more welcomed than first believed; however, the offer to prepare the remedial design at its own expense is simply an agreement to provide what the architect, and the owner, had agreed the architect would provide. Counsel might consider an argument that the architect's conditional offer of a free redesign in exchange for the owner's written assurance of payment of the balance of the fee is a breach of the exclusive remedy.

Given the architect's estimate that the redesign value is \$100,000, the architect is not likely to risk the protection of the exclusive remedy against the condition of

157. See 5 PHILIP L. BRUNER & PATRICK J. O'CONNOR, CONSTRUCTION LAW § 17:90 (2006) (cases cited therein).

158. See *supra* Part III.E.

159. See *supra* Part III.E.

payment. The architect likely would perform the redesign even without the owner's assurance of payment. The reason is that if the architect performs the obligation to redesign for free, it fulfills its contractual obligation and does not breach the contract. Then, if the owner fails to pay the \$1 million balance, the architect may terminate the contract and seek its "*anticipated profit on the value of the services not performed.*" The architect maintains the right to be made completely whole, less its actual cost of performing the redesign. Consequently, the architect bears an estimated \$100,000 risk while the owner potentially bears in excess of \$7.9 million in losses, exclusive of the costs to be paid by the owner to a new architect to complete the design professional's services.

VIII. CONCLUSION

From the perspective of the owner, traditional statutory and common law notions of fairness, responsibility, and liability typically should remain in place. Usually, owners cannot effectively control the risk of design professional errors or omissions. Usually, owners are not at fault for the design professional's mistakes. Most of the risk of loss is placed on the design professional by applicable law absent a contractual reallocation of the risk. Design professionals can obtain insurance to cover these risks. Owners will, and should, pay for adequate design professional insurance coverage. If this risk of loss nevertheless is to be reversed, owners must explicitly recognize the reversal and plan to absorb the reallocated risk.

