CONSEQUENTIAL AND LIQUIDATED DAMAGES: INSURANCE IMPLICATIONS AND THE TRANSFERRENCE OF RISK

In a casual setting recently the topic of liquidated damages (LDs) came up among a group of large contractor risk managers.

Overheard were some general observations: “These seem to be more prevalent lately – must be due to owners having the upper hand in negotiations.” “I don’t mind liquidated damages as at least I know my worst case scenario for delay and can plan for that. If the contract had an ‘actual damages’ wording we would walk away.” “I don’t get this – we have a mutual waiver of consequential damages in our contract and I think that protects us and shares the risk with the owner.” And most frequently, “What’s the marketplace doing to insure LDs? I hear that they are available yet I haven’t been able to find economically viable solutions.”

While these comments were often specifically related to liquidated damages and the ability to insure them, similar comments often arise about consequential damages and how insurance responds. The entire issue of these types of clauses is complex with state laws, types of work and new delivery approaches, including Integrated Project Delivery, all having an impact on how they may be used. While all of these and other factors need to be considered when evaluating these clauses, the purpose of this Blueprint is to discuss in broad terms how LDs and consequential damages are viewed by the insurance community, what damages “standard” insurance policies may address and the ability to directly insure LDs.

WHY HAVE CONSEQUENTIAL DAMAGE AND LIQUIDATED DAMAGES CLAUSES?

These clauses are used by contract drafters to focus construction parties on completing projects on time and within budget. Both are used to establish parameters and damages that will be expected by the owner or other upstream parties should the project not come online or perform per expectations. Distinguishing between these two terms is important as they are frequently used to mean similar things, but in fact they have very different meanings.

CONSEQUENTIAL DAMAGES

Consequential damages are those that are not a direct result of an act but flow from the initial act. An example, useful in thinking
about such damages, is a claim by the owner where the contractor had to be replaced on a project. This resulted in additional costs to complete as the project was delayed. These additional costs in this quick example are typically considered direct damages. The costs associated with the delayed completion, such as loss of rents, are considered indirect or a consequence of the fact that the contractor had to be replaced. In addition, “consequential damages” is often not defined or limited in any way in construction contracts. As a result, it could encompass many liabilities difficult to foresee or quantify, such as damage to brand value (the owner’s brand), loss of customers, the cost of missing seasonal peak revenue (e.g., a sporting season for an arena or stadium) and debt costs arising from an owner exceeding debt covenant thresholds (on corporate debt unrelated to the project financing), thus resulting in higher debt costs.

**LIQUIDATED DAMAGES**

Liquidated damages usually comprise a specified amount of money that the parties agree upon when a contract is signed which will be paid as damages in the event of a breach of the contract. Typically these damages are related to the work not getting completed on time and are expressed as a set dollar amount per day, such as $1000 or more. One reason LDs have been used is the difficulty in quantifying actual damages – a time consuming and contentious process. LDs bring some certainty to the contract and allow both parties to have a common expectation if a project is delayed due to unexcused circumstances. There are several legal precepts on what constitutes appropriate levels of liquidated damages, including delay damages: they are difficult to quantify, they must be reasonable, they are intended to be the “exclusive” remedy for delay and they cannot be considered a penalty but rather compensation for delay.

Both types of damages, liquidated and consequential, have state-specific rulings that apply. Capturing state-by-state nuances is beyond the scope of this *Blueprint*. Rather, we will examine how insurance might apply and offer guidance on how insurance traditionally has viewed these types of damages. For additional background, several well-known rulings on how these damages are defined and applied in contracts are on record.

The best known case, perhaps, for consequential damages is quite old: *Hadley vs Baxendale from 1854 in the UK*. This early case discussed how to categorize damages as direct or consequential and is still used as a guide.

A second case which applies to construction is from the Virginia Supreme Court, *Roanoke Hospital Association v. Doyle & Russell, Inc.* This case is notable as the judge used specific examples of what should constitute direct damages versus consequential damages and is often cited when trying to distinguish between the two.

Both cases (as well as others) are widely available on the internet and can be read in their entirety to get a full flavor of the topic.

**INSURANCE IMPLICATIONS: IS THERE COVERAGE FOR CONSEQUENTIAL DAMAGES OR LIQUIDATED DAMAGES?**

As you might imagine the issue of insurance coverage for contract clauses seeking to establish damages is complex. In discussions of these types of damages we often hear that they are not covered by insurance. In fact there are a number of circumstances where insurance, including Builders Risk, Commercial General Liability, Professional Liability and Environmental Liability, may apply. Each of these has elements – or can be drafted to address – direct covered losses as well as losses arising from those covered losses. We will discuss each line briefly as to how they might apply, but in all cases the specific facts of a loss will determine how coverage could apply.

**COMMERCIAL GENERAL LIABILITY**

The CGL is a very broad policy that has significant protections for insureds for legal liability for “damages because of” bodily injury or property damage to which the insurance applies. Extensive case law defines its intent as well as a number of amendments allowing underwriters to broaden or narrow coverage based on their assessment of the risks of a specific insured. From a delay or indirect loss standpoint, a place to start when trying to determine if coverage applies under the CGL policy is the definition of what constitutes property damage. This is not to suggest that bodily injury claims don’t cause delay, as they obviously could, but those cases are rare relative to PD, hence the focus on property damage for this discussion.
The ISO definition of property damage in the CG0001 Ed 12 07 is:

"17. “Property damage” means:
   a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
   b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the “occurrence” that caused it."

Clearly the policy will respond to “loss of use” claims, but these must be causally related to the property damage itself.

Examples of these types of claims include loss of rents from a building that was unable to open on time as a result of a liability claim, additional costs related to a delay in a project caused by a property damage claim, and even to some liquidated damages. A variety of cases speak to consequential and liquidated damages and many support the idea of coverage for those which can be shown to arise from a covered property damage claim.

A signature case for this is Mattiola vs. Commercial Union Ins Co., a Pennsylvania case which ruled that liquidated damages can be covered by the CGL policy because the project delay was a result of a covered property damage claim. That case has been cited in others as a way to view how such losses should be addressed, and we encourage you to understand the court’s ruling.

Again this is a complex issue, but a place to start in thinking about coverage under the CGL is to think in terms of indirect costs which arise directly from a covered property damage loss.

**PROFESSIONAL LIABILITY**

Many people think of professional liability when the topic of indirect and economic damages comes up. Over the last decade the evolution of this coverage from focusing on architects and engineers to a much broader emphasis on contractors has been significant. The obvious reasons include the increase in design-build work, contracts which push more construction management and schedule risk to contractors, and more sophisticated technologies in construction, which increase their professional responsibilities.

Professional liability coverage is distinct from CGL in that it specifically addresses economic damages in addition to bodily injury and property damage arising out of professional services.

By definition, a professional liability loss can arise without direct physical loss to tangible property (see the CGL discussion on this point). Therefore, many of the indirect losses that could be considered consequential could fall into the definition of damages under professional policies.
Examples include schedule delays resulting in additional costs arising from design errors, such as a faulty electrical system design that causes an investment company to not close a series of transactions which resulted in lost profits; a change order to fix an issue with a foundation design that caused additional costs for storage of materials; and an owner claimed lost profits for a job due to a scheduling error arising from a professional service. Each of these has aspects of consequential losses as they resulted indirectly from a professional liability claim.

Regarding liquidated damages, many professional underwriters are either silent on the subject or try to limit their coverage to the extent of actual damages arising from a professional claim. Two leading underwriters specifically address liquidated damages in their forms by saying that they will only pay the actual damages that the contractor is responsible for up to the limit of the liquidated damage amount. This is different from just paying the LD amount.

**BUILDERS RISK**

Builders risk is, of course, a completely different type of policy from either professional or general liability. It’s a first-party insurance coverage that (if well written) seeks to address most property damage during the course of construction for most project participants. Since it is not a liability-based coverage, the theory is that this will allow a smoother claim process for damage to the work during construction, as the standard of coverage becomes: *Is there a covered loss and how large is it?* The question for this Blueprint becomes: *Can the builders risk policy address consequential losses and, if so, how?*

The answer is not an easy one for several reasons. First, this coverage has wide flexibility when being placed. Different underwriters have different attitudes toward coverage; no standard policy can be pointed to as definitive on coverage interpretation. Second, the coverage thought of as addressing some consequential loss must be carefully worded and added to the policy. This coverage often is referred to as “soft costs” and pays for indirect losses, such as having to re-do drawings, paying additional interest on construction loans as the project is delayed by a covered loss, or in some cases the owner’s loss of rents or income as the project did not open on time due to a covered direct loss. These obviously have elements of consequential losses. Some underwriters use “Delayed Start Up” coverage to address similar additional costs for delay, particularly on engineered projects where an output from the facility is expected upon completion.

In most cases these coverages address, or are intended to address, actual damages arising from a covered loss in the policy and typically liquidated damages are specifically excluded.

**ENVIRONMENTAL LIABILITY**

There is no coverage for liquidated damages on contractors pollution liability (CPL) policies. The coverage trigger on these forms is a legal obligation to pay a loss as a result of a claim for third-party bodily injury,
Some CPL policies include coverage for the costs to repair real or personal property (of a third party) to substantially the same condition it was in prior to being damaged during the work performed in the course of incurring remediation costs. This is typically referred to as restoration cost coverage. The value determination depends upon such things as the policy form, appraised market value immediately prior to the loss and replacement value, but does not usually include coverage for improvements or betterments.

third-party property damage or remediation costs (a.k.a. clean-up costs or environmental damage) from pollution conditions caused by the contractor’s work. This includes work performed on the contractor’s behalf by subcontractors. Other coverage under these forms generally includes monetary awards or settlements of compensatory damages; and civil fines and penalties, exemplary, multiple and punitive damages where insurable by law, all directly attributable to the covered loss.

On a CPL, the definition of (third-party) property damage includes loss of use and diminution in value, the latter only if the property has been physically damaged. Covered consequential damages here could include lost rent, profit, etc. to third parties.

Some CPL policies include coverage for the costs to repair real or personal property (of a third party) to substantially the same condition it was in prior to being damaged during the work performed in the course of incurring remediation costs. This is typically referred to as restoration cost coverage. The value determination depends upon such things as the policy form, appraised market value immediately prior to the loss and replacement value, but does not usually include coverage for improvements or betterments.

CPL policies can sometimes be endorsed to include development “soft costs” arising from a covered pollution incident. This is more commonly used on a project wrap-up design. Examples of soft costs may include additional financing/interest, taxes, advertising/promotional, legal/renegotiation expenses, architect and engineering fees, licenses/permits and rents. These will vary with the insurer and the circumstances of the risk and coverage and will very likely be subject to a sub-limit and different retention level. There is no coverage for late performance or penalties for breach of contract.
STAND-ALONE LD AND CONSEQUENTIAL DAMAGES COVERAGE

Beyond the various ways insurance policies might address some elements of LDs or consequential damages, the question of market appetite for stand-alone coverage for these is routinely brought up. This has become more frequent in the last few years because contracts have become more aggressive in putting specific requirements in job documents, and the contracting community is often uncomfortable taking on such a potentially significant risk without insurance. In addition, because lenders are vitally interested in jobs getting completed on time to allow them to get repaid, they have been more forceful on insisting that incentives are placed in the contract to encourage timely completion. So the question of availability for this coverage comes up frequently and the answer, at this writing, is simple: “Limited availability, and it’s expensive.”

This statement requires a bit more nuance in addressing the question, however, as there are few choices domestically (U.S./Canada) and a few more in London and Europe. Stand-alone coverage is intended to pay for LDs resulting from late completion or failure to perform per the contract. It is excess over any other available insurance, requires waiting periods to allow a “cure” to get the job done (this acts as a deductible), and requires extensive underwriting, including peer engineering reviews by the underwriter. This process alone has discouraged many firms from pursuing the coverage, since it’s expensive and time consuming. The firm applying for the coverage typically pays for the engineering by the underwriter. If the coverage is not purchased this is a sunk cost by the contractor; if the coverage is purchased it typically gets included in the premium cost. Rates for the coverage are determined job by job and often are a significant percentage of the limit purchased (10% and up is not out of the question).

Those qualifications noted, however, discussion continues about availability, and some carriers have remained in the game particularly for long-standing customers with profitable relationships. Capacity is north of $50 million, but the number of placements is low and infrequent beyond special long-term deals. In summary, the ability to obtain significant limits is difficult, the process can be onerous, and the cost impact to the job continues to make purchasing of stand-alone coverage for LDs rare.

As of this writing, Willis is working with a firm to develop a new facility for smaller jobs (under $50 million) and smaller limits of coverage ($5 million), but the process and terms are not substantially different from the market as a whole. See your Willis Client Advocate®, who can reach out to the resources below for additional information.

A FEW FINAL OBSERVATIONS

The entire topic of consequential damages and LDs is, of course, far more detailed than can be addressed in this brief overview. Our purpose is to focus the reader on how insurance views these damages, point out that definitions are important in discussing these as, in many cases, coverage is available for resulting consequential damages from covered insurance claims, and that the stand-alone market for these is not robust. In addition, various standard contract documents (see the appendix) address consequential damages specifically and often seek to have mutual waivers between the parties incorporated into the contract to avoid them entirely. The fact remains, however, that how to address these by insurance is a question that is raised consistently. We trust that this briefing provides a basis for understanding this issue.
## APPENDIX

### CONTRACTUAL PROVISIONS ADDRESSING CONSEQUENTIAL LOSS

Most of the standard form contracts in use have clauses for consequential damages:

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<th>Contract</th>
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| **AIA A201** | 15.1.6 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 and 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 for the Work.  
This mutual waiver is applicable, without limitation, to all consequential damages due to either party’s termination in accordance with Article 14. Nothing contained in this Section 15.1.6 shall be deemed to preclude an award of liquidated damages, when applicable, in accordance with the requirements of the Contract Documents. |
| **AIA B142** | 3.5 Claims for Consequential Damages  
The Consultant and the Owner waive consequential damages for claims, disputes or other matters in question arising out of or relating to this Agreement. This mutual waiver is applicable, without limitation, to all consequential damages due to either party’s termination in accordance with Section 3.7. |
| **AIA B101** | 8.1.3  
The Architect and the Owner waive consequential damages for claims, disputes or other matters in question arising out of or relating to this Agreement. This mutual waiver is applicable, without limitation, to all consequential damages due to either party’s termination in accordance with Section 9.7. |
| **ConsensusDoc 200** | 6.6 Limited Mutual Waiver of Consequential Damages  
Except for damages mutually agreed upon by the Parties as liquidated damages in section 6.5 and excluding losses covered by Insurance required by the Contract Documents, the Owner and the Contractor agree to waive all claims against each other for any consequential damages that may arise out of or relate to this Agreement except for those specific items of damages excluded from this waiver as mutually agreed upon by the Parties and indemnified below. The Owner agrees to waive damages including but not limited to the Owner’s loss of use of the Project, any rental expenses incurred, loss of income, profit or financing related to the Project, as well as the loss of business, loss of financing, loss of profits not related to this Project, loss of reputation, or insolvency. The Contractor agrees to waive damages including but not limited to loss of business, loss of financing, loss of profits not related to this Project, loss of bonding capacity, loss of reputation, or insolvency. The provisions of this section shall also apply to their termination of this Agreement and shall survive such termination. The following are excluded from this mutual waiver: 6.6.1 The Owner and the Contractor shall require similar waivers in contracts with Subcontractors and Others retained for the Project. |
6.5 Limited Mutual Waiver of Consequential Damages

Except for damages mutually agreed upon by the Parties as liquidated damages in Section 6.4 and excluding losses covered by Insurance required by the Contract Documents, the Owner and the Design-Builder agree to waive all claims against each other for any consequential damages that may arise out of or relate to this Agreement except for those specific items of damages excluded from this waiver as mutually agreed upon by the Parties and indemnified below. The Owner agrees to waive damages including but not limited to the Owner’s loss of use of the Project, any rental expenses incurred, loss of income, profit or financing related to the Project, as well as the loss of business, loss of financing, loss of profits not related to the Project, loss of reputation, or insolvency. The Design-Builder agrees to waive damages including but not limited to loss of business, loss of financing, loss of profits not related to this Project, loss of bonding capacity, loss of reputation, or insolvency. The provisions of this section shall also apply to the termination of this Agreement and shall survive such termination. The following items of damage are excluded from this mutual waiver: 6.5.1 The Owner and the Design-Builder shall require similar waivers in contracts with Subcontractors and Others retained for the Project.