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Direct vs. Consequential Damages

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DIRECT V. CONSEQUENTIAL DAMAGES

Although "direct" and "consequential" damages are distinctively defined, a practitioner never knows with certainty how any judge, jury or arbitrator may characterize a particular element of damages. Due to this inherent unpredictability, liquidated damage provisions and consequential damage waivers are often inserted into construction contracts to protect contractors and owners from unanticipated liabilities. This paper discusses the distinction between direct and consequential damages, representative cases, and agreed contractual remedies that mitigate this uncertainty.

I. General Breach of Contract Damages

The objective in awarding damages for a breach of contract is to provide just compensation for the loss actually sustained by the complaining party.[1] Damages for breach of contract protect three interests: a restitution interest, a reliance interest, and an expectation interest.[2] Regardless of whether the damages are characterized as expectancy, reliance, or restitution, the general measure of damages in a common-law breach of contract claim is just compensation for the loss or damage actually sustained, commonly referred to as the "benefit of the bargain."[3]

II. Distinction Between Direct and Consequential Damages

At common law, damages may be characterized as either "direct" or "consequential" (sometimes also called "special" or "incidental").[4] Direct damages that naturally and necessarily flow from a breach of contract are conclusively presumed to have been foreseen or contemplated by the defendant as a usual and necessary consequence of its wrongdoing.[5] Damages which are allowed because of the defendant's knowledge of special conditions when the contract was made are "consequential" damages; these damages result naturally, but not necessarily, from the breaching party's wrongful acts.[6] Consequential damages are recoverable only if they are foreseeable and directly traceable to the wrongful act and result from it.[7]

A. The theory

The law of consequential damages is traced to the old English case of *Hadley v. Baxendale*[8], in which the court adopted a rule that has been a source of confusion in our jurisprudence ever since: that consequential damages will only be available as compensation for a breach of contract if they were within the reasonable contemplation of both parties at the time they entered into the contract. The court described damages recoverable in the event of a breach

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[1] *Phillips v. Phillips*, 820 S.W. 2d 785 (Tex. 1991)
[2] *See O'Farrill Avila v. Gonzalez*, 974 S.W. 2d 237, 247 (Tex. App. — San Antonio 1998, pet. denied).
[3] *Bowen v. Robinson*, 227 S.W.3d 86, 96 (Tex. App. — Houston (1st Dist.) 2006, pet. denied.)
[4] *Arthur Andersen & Co. v. Perry Equip. Corp*., 945 S.W.2d 812, 816 (Tex. 1997)
[5] *Cherokee County Cogeneration Partners, LP v. Dynegy Marketing and Trade, et. al*, 305 S.W. 3d 309 (Tex. Civ. App. Houston 2009).
[6] *Stuart v. Bayless*, 964 S.W. 2d 920 (Tex. 1998)
[7] *Id*. at 921.
[8] 9 Ex. 341, 156 Eng. Rep. 145 (1854)

as those which would be considered to arise naturally in the usual course of events from a breach or that would reasonably be supposed to have been in the contemplation of both parties at the time they made the contract. In addition, special damages arising from "special circumstances under which the contract was actually made" are recoverable if "communicated by the plaintiffs to the defendants, and thus known to both parties".

The law of consequential damages is a product of the tension between the legal objective of fully compensating the victim of a breach of contract and the principle of determining agreed allocations of risk. Parties to a contract are deemed to have expected the normal and usual risks in the absence of specific contractual language to the contrary. Consequential damages, which represent additional risks due to unusual circumstances of the non-breaching party, are not recoverable unless the nonbreaching party can establish that the parties were aware of the special circumstances at the time they entered into the contract (therefore intending to allocate such risks to the breaching party) or reasonably should have foreseen such damages at the time the contract was made.

Limitation of consequential damages according to their foreseeability at the time the contract was made sounds straightforward. A review of decisions applying this principle, however, provides little confidence about the predictability of whether identical damages will be categorized as consequential vs. direct in any given case. As noted in a Yale Law Journal article written more than fifty years ago[9]:

> As a fiction, the foreseeability rule fails to distinguish foreseen from unforeseen losses. In operation the rule treats losses which were foreseeable by defendant as if they were foreseen by him; it treats losses not foreseeable by defendants as if they were foreseen only by the plaintiff. But the loss of profits resulting from breach is seldom foreseen by either plaintiff or defendant at contract time.

There is a natural tendency in hindsight to view the actual result of the breach as having been reasonably foreseeable at the time of the contract. This tendency, coupled with the desire to fully compensate the victim of the breach, has resulted over the years in an abundance of conflicting judicial opinions in which specific damage elements on similar facts have been labeled as both direct and consequential.

B. In Practice

The characterization of damages as consequential or direct depends on the language of the contract and the facts of each case. Consider the following Texas cases:

1. In *Wade and Sons, Inc. v. American Standard, Inc.*[10], the contract contained a provision that excluded the supplier's liability "for any incidental or consequential damages resulting from the use, misuse, or inability to use the product" regardless of whether such damages are sought based on breach of warranty, breach of

[9] Note, Lost Profits as Contract Damages: Problems of Proof and Limitations on Recovery, 65 Yale L.J. 992, 1021 (1956)
[10] 127 S.W. 3d 814 (Tex. App. — San Antonio 2003, review denied).

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