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## Be slow to waive consequential damages

Just about every purchase and sale agreement affecting real property contains a provision titled “Waiver of Consequential Damages.” The caption and the location of these provisions, often buried in the agreement’s miscellaneous section, make them traps for the unwary purchaser.

The provisions come in different shapes and sizes, but the key terminology is substantially the same from one provision to the next. “Each party hereby forever waives and releases, and covenants not to seek or retain, any claims for consequential, incidental, indirect, special or punitive damages as against the other party.” That is a broad waiver.

Punitive damages arise outside a contract and are therefore likely to be unavailable on account of a contractual breach. The U.S. Supreme Court said in *City of Newport v. Fact Concerts Inc.*, 453 U.S. 247 (1981), “punitive damages by definition are not intended to compensate the injured party, but rather to punish the tortfeasor whose wrongful action was intentional or malicious, and to deter him and others from similar extreme conduct.”

Since punitive damages are not, for the most part, available on account of a contractual breach, and since claims outside a contract are remote, a purchaser can readily accept a waiver of punitive damages.

Consequential damages are an altogether different matter. However, before we explore the impact of a consequential damages waiver, we should review the three principal types of damages that a real property purchaser could suffer and their close relationship to one another.

- Direct damages, which are also referred to as general damages, are losses that are the necessary and usual result of the kind of breach committed without considering any special circumstances.

While direct damages are often measured as the difference between the value of the asset as purchased and its fair market value, direct damages could also

be measured by the cost necessary to put the purchaser in the position it would have been had the breach not occurred. Practitioners often describe direct damages as those that are the natural, probable and reasonable consequence of a breach.

- Incidental damages are generally the out-of-pocket costs a purchaser sustains to correct a breach of a covenant, representation or warranty. They are closely akin to direct damages.

- Consequential damages are the losses that a purchaser sustains as a result of a breach that would not normally and necessarily result from the breach in the absence of some special or unusual circumstance.

A bright-line test for the difference between direct damages and consequential damages does not exist. Courts have generally described direct damages as those that naturally and generally result from the breach, and consequential damages as those that are the consequence of special or unusual circumstances. The challenge is in determining what exactly qualifies as special or unusual circumstances. Consider the following — a real life example.

The purchaser of a luxurious spa hotel acquires an operating, fully functional property, but shortly after closing finds that the leach field is incapable of providing adequate drainage for the property’s wastewater. The municipality with jurisdiction over the property orders the purchaser to curtail its operations while the condition is studied, the repairs are designed, the work is permitted and the corrective work is performed.

The estimated downtime is approximately six months. The cost of the analysis and repairs is projected to be about \$150,000, but the lost revenue is approximately \$800,000, and the lost net operating income falls somewhere between these two figures — depending upon who is performing the calculation.

Although the seller did not represent and warrant the adequacy of the leach field or its sufficiency for handling the

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property’s wastewater, the seller did represent that the property was not the subject of any notices of violation of applicable laws. However, the municipality had issued a notice that the leach field failed to comply with the city’s ordinance and mandated repairs.

The seller had previously performed certain required repairs and therefore deemed the violation to have been cured. However, by failing to obtain an inspection and sign-off, the seller failed to cure the violation. The purchaser closed and subsequently learned of the property’s violation of law and the seller’s breach.

Under the purchase agreement, the purchaser waived its right to recover consequential damages in the event of the seller’s breach.

What are the purchaser’s damages? The cost of the analysis and repairs (\$150,000) are certainly direct damages. But what about the lost revenue and net operating income? Are these consequential damages or direct damages?

Certainly every purchaser confronting this set of facts would take the position that the lost revenue is the natural, probable and reasonable consequence of the seller’s breach. These are direct damages, and the purchaser is entitled to recover them. The municipality’s action in shutting down a portion of the property is a reasonable and foreseeable consequence of the failure of the property to comply with applicable law.

Not so fast, asserts the seller. The cost of repairs corrects the breach. Who knows how much revenue could have been earned by the property? The seller offers to pay the cost of putting the purchaser in exactly the position it

would have occupied had there been no breach — but not a penny more.

Unfortunately for the parties, the next stop in this journey is the courthouse. The difference between direct and consequential damages will become a fact intensive analysis, twisted and contorted to conform with each party’s view of the law defining direct and consequential damages. If the law does not provide a simple or understandable distinction between direct damages and consequential damages, the parties are left to time-consuming and expensive legal proceedings.

The lesson is simple enough: A purchaser waives the right to recover consequential damages at his or her peril. But, in light of the prevailing custom of waiving consequential damages in real property purchase and sale agreements, how can a purchaser achieve a good result?

Instead of using the term consequential damages, consider waiving “remote” or “speculative” damages. Avoid including “incidental damages” in a consequential damages waiver since, as stated above, incidental damages are often a form of direct damages. Also avoid the term “lost profits.” Lost profits in a nascent business venture are quite a bit different from lost profits at an operating hotel. Be as specific as possible in defining the damages that are being waived, and further, provide an example of the type of damages that are not being waived.

Finally, perhaps the best way for a purchaser to address consequential damage waivers may be to do away with them altogether.

Somewhat surprisingly, a seller may be receptive to the request.

In light of the overall cap on damages that a seller often demands from a purchaser, it is not unreasonable for a purchaser to say “we cannot recover very much in absolute terms, but we should not be in a position where we have a good claim, and we cannot recover our damages.” If we have a good claim, we deserve to be made whole — at least to the limit of the seller’s post-closing liability.