Direct And Consequential Damages In Contract Disputes

Law360, New York (November 03, 2011, 3:08 PM ET) -- In a recent dispute where Haynes and Boone LLP represented the claimant, an arbitrator awarded over $4 million to a pipeline company that had purchased and installed respondent’s defective valves. The award included over $2 million in out-of-pocket costs, nearly $900,000 in past and future lost profits, and over $600,000 in attorneys’ fees.

The award’s linchpin was the fact that the parties’ contract did not include a clause excluding respondent’s liability for consequential damages. In a celebrated New Jersey case, arbitrators likewise awarded $14.5 million in damages on a $600,000 construction contract because the contract did not include a clause barring consequential damages. See Jason L. Richey & William D. Wickard, Consequential Damages in Today’s Construction Industry, Constructioneer, *10, May 5, 2008. The New Jersey Supreme Court affirmed the award. Perini Corp. v. Greate Bay Hotel & Casino Inc., 610 A.2d 364 (1992).

These cases illustrate again the importance of properly drafted limitation-of-liability contractual clauses. But even this precaution has its limits. Texas case law shows that direct damages alone can be substantial depending on the facts of the case. Damages that are usually classified as consequential can sometimes be treated as direct damages depending on the contract’s language. Counsel should mind these dangers as they draft their contracts.


For pleading purposes, under Texas law, actual damages can be split into direct and consequential damages. Arthur Andersen & Co. v. Perry Equip. Corp., 945 S.W.2d 812, 816 (Tex. 1997). Direct damages result naturally and necessarily from the defendant’s wrongful conduct. The defendant will have necessarily foreseen these damages in case of breach.

Consequential damages result naturally but not necessarily from the defendant’s wrongful conduct. Nonetheless, consequential damages must be foreseeable and directly traceable to the breach of contract. The 19th Century English case of Hadley v. Baxendale established the foreseeability requirement. (1854) 156 Eng. Rep. 145 (Exch. Ct.).
Texas law does not require a plaintiff to plead direct damage claims in its petition. Green v. Allied Interests Inc., 963 S.W.2d 205, 208 (Tex. App.—Austin 1998, pet. denied). But a plaintiff must specifically plead consequential damage claims. Tex. R. Civ. P. 56. (“[w]hen items of special damage are claimed, they shall be specifically stated.”). Equity justifies this distinction. See Jeffrey R. Cagle et al., The Classification of General and Special Damages for Pleading Purposes in Texas, 51 Baylor L. Rev. 629, 637 (1999).

Direct damages are sufficiently predictable that they require no special pleading. Not so consequential damages, which require notice to the defendant. Direct and consequential damages are categorized on a case-by-case basis. See id. The classification is a question of law, and is not always the same from one court to the next. Powell Elec. Sys. Inc. v. Hewlett Packard Co., No. 01-09-00876-CV, 2011, *2 (Tex. App.—Houston [1st Dist.] Apr. 28, 2011, no pet. h.). In case of doubt, a plaintiff should assume that damages are consequential and plead them accordingly. Cagle, supra, at 635.

The distinction between direct and consequential damages is important when the parties’ contract contains a clause barring consequential damages. Reynolds Metals Co. v. Westinghouse Elec. Corp., 758 F.2d 1073, 1079 (5th Cir. 1985). The benefit of the bargain that is directly and strictly tied to the contract is a measure of direct damages. Cagle, supra, at 663–64 (citing Hess Die Mold Inc. v. Am. Plasti-Plate Corp., 653 S.W.2d 927, 928–29 (Tex. App.—Tyler 1983, no writ).

In Hess Die Mold, the buyer expected to pay $23,445 for a piece of equipment. The seller could not honor the deal. The buyer had to purchase the equipment from another seller at a price of $47,500. The court held that the difference ($24,065 (sic)) measured the buyer’s direct damages.

Lost profits, lost sales, incidental damages and most other damages are consequential damages. Cagle, supra, at 665–68. Lost profits on the contract itself, as in Hess Die Mold, are direct damages. Cherokee County Cogeneration Partners LP v. Dynegy Mktg. & Trade, Dynegy GP Inc., 305 S.W.3d 309, 314 (Tex. App.—Houston [14th Dist.] 2009, no pet.). Lost profits on other contracts, but that result from the breach, are consequential damages. Id.

But certain damages that would normally be categorized as consequential can become direct damages if the contract specifically contemplates them. McKinney & Moore Inc. v. City of Longview, No. 14-08-00628-CV, 2009, *5 (Tex. App.—Houston [14th Dist.] Dec. 8, 2009, pet. denied) (“by definition, if particular damages are specifically accounted for in the contract, they are direct, not consequential, in nature.”).

Four Texas cases illustrate the distinction between direct and consequential damages and their case-by-case specificity. See, e.g., Hycel Inc. v. Am. Airlines Inc., 328 F. Supp. 190, 194 (S.D. Tex. 1971) (“what amounts to special [i.e., consequential] damages is largely dependent on the circumstances of each case”).

Cherokee County Cogeneration Partners shows that lost profits that are expressly referred to in a contract qualify as direct damages. Cherokee, 305 S.W.3d 309. Dynegy was under contract to provide natural gas to Cherokee at a fixed price for Cherokee’s use or resale. Dynegy invoked the contract’s force majeure clause during and after Hurricanes Katrina and Rita in 2005. It did not deliver the full contractual amounts of gas between August and October of that year. The price of gas “skyrocketed” during this interval, reaching five to 10 times the contractual amount.
Cherokee sued for breach of contract. A contract clause stated that Cherokee’s damage measure in case of under-delivery would be the undelivered gas volume times the differential between the market and the contractual prices. The court held that Dynegy’s interference with Cherokee’s contractual right to its profits (from the purchase of gas at below-market prices) “would naturally and necessarily cause Cherokee to suffer direct damages.”

Reversing the trial court, the Court of Appeals rejected Dynegy’s argument that Cherokee sought consequential “lost-profits” damages that were barred by contract.

In a construction case, Tennessee Gas Pipeline (“TGP”) hired Technip USA to upgrade a pipeline. Tenn. Gas Pipeline Co. v. Technip USA Corp., No. 01-06-00535-CV, 2008, at *2 (Tex. App.—Houston [1st Dist.] Aug. 21, 2008, pet. denied) (mem.op.). The project experienced delays and a lawsuit was filed. TGP demanded that Technip pay for expenses that TGP incurred because of the delays. Technip maintained that these expenses were contractually barred consequential damages.

The court of appeals closely followed the lower court in holding that the damages were mostly consequential. Some damages, however, were held to be direct. The contract stated that TGP would provide services to the job sites, e.g., permits, water, power and operations personnel. The court held that “the parties clearly contemplated” that TGP would carry these service expenses through the duration of the project. Service expenses that TGP incurred because of project delays were, therefore, direct damages reimbursable by Technip.

On the other hand, and as an example, the court denied TGP’s claim for the expenses it incurred when it was forced to rent a backup generator. Technip’s allegedly premature removal of the old generator imposed this unexpected expense on TGP. These damages were consequential, and not direct, because they did not necessarily result from the breach.

Tennessee Gas illustrates the double-edged nature of assignment-of-responsibility contractual clauses. These clauses spell out who is responsible for what in a contract. They dispel ambiguities and may serve the parties well during contract execution. But these clauses may also define the measure of direct damages that the parties may claim in litigation. These two consequences create an inevitable tension that the parties must consider during the contract-drafting phase.

The line between direct and consequential damages can also be blurred in mixed contracts for goods and services, as the following case illustrates. Westinghouse sold a transformer to Reynolds Metals together with installation services by a “competent” engineer. Reynolds Metal, 758 F.2d at 1074–75. The $250,000 contract barred consequential damages.

The transformer had a design defect, and the commissioning engineer was inexperienced. The transformer broke less than a year after its installation, and Reynolds incurred almost $110,000 in repairs. The warranty had lapsed because Reynolds had warehoused the transformer for almost two years between delivery and installation. Therefore, Reynolds’ only chance of recovery resided with the services contract.

The jury found that Westinghouse had breached the contract by not sending a competent engineer. It also found that that the breach was responsible for all of Reynolds’ damages. It awarded Reynolds its repair expenses ($110,000) in damages. The court of appeals affirmed the breach of contract finding but struck the damage award. It held that the repair expenses were consequential damages and were, therefore, barred by contract.
The proper measure of direct damages was the difference between the value of the services that were promised and that of those that were delivered, i.e., the difference between the price of a competent engineer and that of an inexperienced one. This amount was presumably a trifle because the engineer was on site only a few days. The court ordered a new trial for the damages.

Finally, in Powell, Hewlett Packard Co. (“HP”) hired Powell Electrical to retrofit the breakers at its power substation. Powell, 2011, at *1. Powell unintentionally crossed a pair of breaker cables when it reconnected them. One of HP’s two transformers failed because of the crossed cables and required repairs. HP brought in a temporary transformer for the duration of the repairs, and eventually sued Powell to recover all of its costs.

One of the issues submitted to the court of appeals was whether HP’s damages were direct or consequential. The contract barred the latter. The Powell court held that the transformer damages were direct damages because they were “inherent in the nature of the breach of Powell’s contractual and warranty obligations to HP.” The parties had necessarily foreseen that crossed cables would fail the transformer and force HP to incur repair expenses.

In the court’s words, “[n]o additional link in the causal chain was necessary to bring about the injury or the damages.” In any event, the unlanding and relanding of the cables was part of the scope of work, and the contract expressly contemplated that expenses could be incurred should Powell performed defectively.

HP’s expenses for the temporary transformer, however, were consequential damages. HP’s power substation had the capability to operate temporarily on a single transformer (it had two). This capability was a basis of the contract, and the parties could not be “conclusively presumed to have foreseen” that Powell’s error would require HP to supply a temporary transformer.

Powell also confirmed that the Fifth Circuit’s holding in Reynolds Metals was properly reasoned. The transformer design defect, which was past limitations, was “a causal link that brought about Reynolds’ damages.” The poor installation was the basis for a meritorious breach of services contract claim. But the installation was not directly responsible for the transformer’s failure (it “was one step removed”). Under these conditions, the repair expenses were necessarily consequential damages.

These cases show that the line between direct and consequential damages is very fact-specific. Damages that flow naturally and necessarily from the defendant’s conduct are direct damages. Damages to a transformer blown by crossed cables are direct. Damages that are explicitly contemplated in the contract are also direct damages, including contemplated lost sales or lost profits.

Contractual assignment-of-responsibility clauses can create bases for direct damage claims. Contracting parties cannot assume that a clause barring consequential damages will shield them from all but the most direct damages. Counsel must try to anticipate at the drafting stage, and to the extent possible, the scope of direct damages under the contract terms. Careful analysis in light of the above cases might reveal legal vulnerabilities that the drafter can redress with appropriate language, or factor into the contract’s risk analysis.

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