Limitation of Liability in Commercial Contracts: Indirect and Consequential Loss

English law is frequently chosen as the governing law of the contract in international transactions, even though neither party to the agreement is English. Many Norwegian companies that trade with English or other international undertakings often agree to English law as the governing law of the agreement - perhaps without a comprehensive overview of the implications this may have on the various contractual clauses. In this second article on the limitation or exclusion of liability under English law, we give a brief overview of the legal framework within which it is possible to limit or exclude liability for indirect or consequential losses under English law.

Tuesday, April 4, 2017

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Commercial parties entering into an agreement – whether it is an agreement for the sale of goods, a distribution agreement, or a cooperation agreement – will generally be concerned about the liability they may incur arising from their contractual obligations. Exclusion clauses can be found in nearly all such ‘business-to-business’ contracts, and both parties will have a separate interest in drafting the clause in such a way as to minimise their own liability if things go wrong.

Frequently, limitation/exclusion clauses include reference to “consequential” or “indirect” loss. However, there is often a misunderstanding about what these terms mean or how to draft clauses to ensure that they exclude all the intended losses. One common misunderstanding is that indirect/consequential loss includes all financial losses which arise as a consequence of the breach.

The main rule for determining liability for damages arising out of a breach of contract can be found in a judgment dating back to 1854 in the case of Hadley v Baxendale. Pursuant to this judgment a person who breaches a contract is generally liable to the innocent party for any loss that falls within one of the following two “limbs”:

1. Loss that arises “naturally” or “according to the usual course of things” from the breach. The courts often refer to this first limb as “direct” loss.

2. Such additional loss as the parties would, at the time when they made the contract, have reasonably expected to be the probable result of such a breach. The courts generally refer to this second limb as “consequential” or “indirect” loss.

The contractual parties are assumed to possess a certain amount of knowledge at the time they entered into their contract. Such assumed knowledge is that which the reasonable person is taken to know in the “ordinary course of things.” Accordingly, the parties are taken to foresee loss which is not unlikely to happen as a result of a breach of contract in the ordinary course of things. This type of loss is known as “first limb” loss.

In addition to the assumed knowledge the parties are taken to have at the time they entered into their contract, there is also the knowledge that they actually held of special circumstances outside the ordinary course of things. For example, at the time the contract was entered into, a party may have been aware of special circumstances which would give rise to additional damage, other than that which follows in the ordinary course of things. Loss which arises from this actual knowledge is known as “second limb” loss after Hadley v Baxendale.

Damage or loss which does not fall within one of the two limbs is too remote and is therefore not recoverable.

When a contractual exclusion clause only refers to the exclusion or limitation of liability for “consequential” loss or damage, it will only exclude loss under the second limb of Hadley v Baxendale. The scope of such exclusion may therefore be far narrower than intended. In particular, if the intention was to exclude liability for all loss that is a consequence of a breach including, for example, loss of profit.

It is common that parties will seek to exclude liability for loss of profit. However, it is a common drafting error that exclusion of liability clauses are ambiguous as to whether liability both for (i) profit arising in the ordinary cause of things (i.e., a “first limb” loss), and (ii) profit arising by reason of special circumstances within the parties’ knowledge (i.e., a “second limb” loss, commonly referred to as “consequential loss”) is excluded. By defining profit as a “consequential loss”, such clauses often only exclude liability for second limb lost profit. Lost profit which arises in the ordinary course of things is not construed as “consequential loss” and is therefore generally not excluded by such wording.

When drafting an exclusion clause it is therefore important to make clear whether references to “loss of profits” are to both the direct and indirect kind, or only one or the other.
In the case of Polypearl Limited v E.on Energy Solutions Limited, Polypearl claimed that E.On Energy Solutions was in breach of a minimum spend commitment under an agreement for the sale/purchase of insulation products. Polypearl claimed loss of profits of £2.1m on the shortfall and, as a preliminary issue, the court had to consider whether the following clause excluded liability for all loss of profit or for indirect loss of profit only:

"(10.1) Neither party will be liable to the other for any indirect or consequential loss, (both of which include, without limitation, pure economic loss, loss of profit, loss of business, depletion of goodwill and like loss) howsoever caused (including as a result of negligence) under this Agreement, except in so far as it relates to personal injury or death caused by negligence."

Polypearl argued that its lost profits on the shortfall were a direct loss, and the judge agreed. The judge noted that the words in parenthesis made the meaning of the clause ambiguous. Did these words mean that Clause 10.1 applied only to indirect or consequential loss of profit? The court ruled that the clause excluded liability for indirect/consequential loss of profits, and not direct loss of profits. This meant that Polypearl could recover its loss of profits under the first limb of Hadley v Baxendale.

In contrast, in the recent case of Star Polaris a clause excluding liability for "consequential or special losses" was interpreted as meaning "all losses caused as a result or consequence of the breach". Due to the language of the clause and the specific context of the case, the court found that the parties must have intended the phrase "consequential or special" to mean something different from the well-recognised meaning established in Hadley v Baxendale.

These cases serve to illustrate the uncertainties that may arise from a poorly drafted exclusion clause if a dispute arises between the parties. The latter also highlights the significant weight placed on the context of the clause when a commercial contract is entered into between two sophisticated parties.

It seems clear from case law that ambiguity around whether a particular type of loss is excluded or not commonly arises where references to specific types of loss (e.g. loss of profit, revenue, goodwill etc.) are bundled in with a reference to "indirect" or "consequential" loss. If the intention is to exclude liability for a certain type of loss, whether the loss is direct or indirect, then one way to avoid this ambiguity is to separate out the exclusion of liability for indirect loss and the exclusion of liability for that specific type of loss.

In any event, care should be taken when including a standard exclusion of liability clause which may have unintended consequences if not carefully drafted. Apart from the obvious risk of omitting certain losses which should have been excluded, it is not safe to assume that an exclusion clause that has been used in a previous contract will be interpreted in the same way in a different contract. It will all depend on the context.

As a general rule, exclusion clauses are interpreted against those seeking to rely on them, so it is important to ensure they are correctly drafted. A good tip is to conduct a risk assessment prior to entering into a new contract. This way you can clearly identify the liability that you want to exclude before you start drafting.

Steenstrup Stordrange’s English law team has extensive knowledge of all aspects of commercial contract law. Our team has experience in drafting, negotiating, and reviewing all types of commercial contracts with the view to minimise risk and protect our clients’ financial interests.

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