Exploring Limitations of Liability and Exclusions of Categories of Loss

By Patrick Mead, Partner

Introduction

There is a distinct between an exclusion clause, the effect of which is to either absolve a party for the consequences of a breach of contract or duty or to define substantively the limit of the duty by negating obligations that the law would otherwise impose, and a liability cap, the purpose of which is to limit a party’s exposure up to a pre-determined amount or percentage of contract value.

Often, these legal mechanisms operate in tandem with provisions in relation to liquidated damages (which are not considered to be exclusory, operating in theory for the benefit of both parties) and insurance and indemnity provisions within a contract, to create a finely balanced risk regime.

Such clauses are construed ‘...accordingly to their natural and ordinary meaning, read in light of the contract as a whole, thereby giving due weight to the context in which the clause appears, including the nature and object of the contract, and where appropriate, construing the clause contra proferentum in case of ambiguity…’

Many contractors rely on such clauses to manage their risk of damages arising out of the performance of contracts into which they enter – particularly in significant process engineering and contract mining agreements - where exposure to unlimited damages will be often unacceptable.

If the starting point is that a contractor will not accept liability for unlimited damages, a number of different outcomes can be achieved by adoption of appropriate exclusions, limitations or caps. Accordingly, it is not uncommon to now see clauses drafted to ensure that liability for all damages is capped at a percentage of the contract sum or an annual amount, in the case of a mining services contract.

Other than in respect of a provision for liquidated damages (which itself is likely to be capped at a
percentage of the contract sum) the contractor may insist upon a complete exclusion for damages for loss of profit, loss of use and business interruption, or alternatively seek to cap any such exposure to the limit of any applicable insurance.

Process engineering and process design risks are of real concern, given the potential for loss to the client over life of plant from shortfalls in production in the event that the plant is unable to meet prescribed performance criteria. Accordingly, a contractor will commonly seek to cap its total liability for a shortfall in production to the lesser of a percentage of the contract value or a fixed dollar amount.

Often the principal will insist upon exemptions of particular matters or losses when faced with a blanket exclusion. If the contractor agrees to this, it will often only do so on the basis of a further cap on liability in respect of the matters not subject to the blanket exclusion.

In a number of reported cases, parties which had contracted for the design and installation of plant and equipment sought to take the benefit of blanket exclusion. If the contractor agrees to this, it will often only do so on the basis of a further cap on liability in respect of the matters not subject to the blanket exclusion.

In a number of reported cases, parties which had contracted for the design and installation of plant and equipment had sought to take the benefit of exclusion clauses in their contracts in defence of claims arising out of the performance of that plant or equipment.

Often clauses sought to exclude any entitlement by the principal to pursue recovery in relation to what has been generically referred to as ‘indirect’ or ‘consequential loss’.

There have been a series of decisions by the English and Australian Courts in the past two decades that have affected the interpretation of these clauses and suggested avenues of recovery, notwithstanding their inclusion in contracts of this nature.

Cases such as British Sugar PLC v NEI Power Product Ltd & Anor (1997) 87 BLR 42, Deepak Fertiliser & Petro Chemical Corporation v Davy McKee (London) Ltd & ICI Chemicals and Polymers Ltd (1991) 1 Lloyd’s Rep 387 and BHP Petroleum Limited v British Steel & Daimine (1999) 2 Lloyd’s Rep 523 suggested that fixed costs and overheads, increased production costs, and sometimes even ‘loss of profits’ claims would not be excluded by consequential loss exclusions commonly found in a number of the standard form contracts upon which contractors have traditionally relied.

The case of Pegler Ltd v Wang (UK) Ltd (No 1) [2000] BLR 218 seemed to widen the scope of losses claimable as ‘direct and natural losses’. Loss of sales, loss of opportunity to increase margins, loss of opportunity to make staff cost savings and wasted management time were all considered to flow directly from the breach and were recoverable.

The law in Australia had appeared to be following a similar path, as demonstrated in the case of GEC Marconi Systems Pty Ltd v BAP Information Technology Pty Ltd [2003] FCA in which losses to a third party such as the benefit of a head contract (lost future profits) and increased project costs were considered by Finn J of the Federal Court to fall within the first limb of Hadley v Baxendale [1854] 9 Exch 341, and thus were recoverable as losses directly resulting from the breach.

Recent case authorities

There are, however, a number of more recent Australian decisions in relation to the interpretation of so called ‘Consequential Loss’ exclusion clauses that have dramatically altered the legal landscape in this country.

It is convenient to start with Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd [2008] 19 VR 358; [2008] VSCA 26. In that case, the Victorian Court of Appeal moved away from the UK position, which had found that ‘consequential losses’ in the context of an exclusion clause are losses that fall within the second limb of the rule in Hadley v Baxendale [1854] 9 Ex 341; the two limbs being:

1. Losses such as may fairly and reasonably be considered either arising naturally, that is, according to the usual course of things, from such breach of contract itself; or

2. Losses such as may reasonably be supposed to have been in contemplation of both parties, at the time they make the contract, as the probable result of the breach of it.

In the case of Peerless, the Court interpreted ‘consequential’ by reference to the dichotomy between ‘normal loss’ and ‘consequential loss’ described in earlier editions of McGregor On Damages (15th Ed (1988) at [26] and following).

The Court referred to ‘normal loss’ as ‘the loss that every plaintiff in a like situation will suffer’. Nettle JA [at 93] saying: “In my view, ordinary reasonable business persons would naturally conceive of ‘consequential loss’ in contract as everything beyond the normal measure of damages, such as
profits lost or expenses incurred through breach … it was not correct to construe ‘consequential loss’ as limited to the second rule in Hadley v Baxendale’.

With respect to His Honour, it has never been clear to the author why ‘profits lost or expenses incurred through breach’ could not be ‘normal loss’ depending on the particular circumstances involved.

The next decision for consideration is that of Bleby J in 2012 in Alstom Ltd v Yokogawa Australia Pty Ltd (no 7) SASC 49.

In that case the Judge said [at 281]: ‘To limit the meaning of indirect or consequential losses and like expressions, in whatever context they may appear, to losses arising only under the second limb of Hadley v Baxendale is in my view, unduly restrictive and fails to do justice to the language used. The word ‘consequential’, according to the Shorter Oxford Dictionary means ‘following, especially as an effect, immediate or eventual or as a logical inference’. That means that, unless qualified by its context, it would normally extend, subject to rules relating to remoteness, to all damages suffered as a consequence of a breach of contract. That is not necessarily the same as loss or damage consequential upon a defect in material where other remedies are provided.’

Then [at 289], it was said: ‘Not only do I respectfully prefer the reasoning of the Victorian Court of Appeal to that of the English authorities, but as a matter of precedent I regard it as a more persuasive authority.’

Then [at 290 and 292]: ‘The expression ‘indirect ….or consequential loss’ appears, in this case, as part of a freestanding and powerfully expressed exclusion clause…..although it must be read against the background of the qualified exposure of YDRML to the exclusive remedies of Liquidated Damages and reimbursement of Performance Guarantee Payments. The article in question was intended to operate in respect of potential liability for loss incurred by Alstom, which was caused by breach of contract by YDRML in circumstances other than those giving rise to the payment of Liquidated Damages and reimbursement of Performance Guarantee Payments. The words must be given their ordinary and natural meaning. In those circumstances any loss consequential or following, immediate or eventual, flowing from a breach of contract by YDRML is excluded from recovery by Alstom…..In my opinion [it] is sufficient to exclude liability for any loss other than in respect of Liquidated damages and Performance Guarantee Payments.’

The Judge went on to say [at 293]: ‘Thus far I have only been concerned with the expression ‘indirect….or consequential loss’ as it appears in Art 3. The other significant expression in that Article is ‘economic …loss.’

Then [at 297]: the words ‘economic loss’ appear as part of the composite expression ‘any indirect, economic or consequential loss whatsoever’ [the judge placing weight on the parties using the words ‘any …whatsoever’ as indicating an intention that the parties adopt ‘that composite expression in the widest possible terms’].

Then [at 302]: ‘That means that the expression ‘economic loss’ must be given its ordinary meaning. That is extremely wide. In tort it includes any financial loss not consequent upon loss of or damage to property in which the plaintiff has a proprietary or possessory interest or consequent upon personal injury to the plaintiff. It is difficult to conceive how any of the claims by Alstom could be for other than economic loss sustained by Alstom’.

Further [at 303]: ‘Alstom does claim additional costs incurred in providing additional personnel and resources in performing…..work the responsibility of YDRML …some of that might be described as work having to be performed as a result of physical damage to items of plant. However that does not mean that Alstom’s claim is not for economic loss.’

And [at 304]: ‘there are no other claims by Alstom which could be described as for other than economic loss.’

Then finally [at 315]: ‘It follows……that any other claim by Alstom [other than for Liquidated Damages and Performance Guarantee Payments] for alleged breaches of contract by YDRML cannot succeed and must be dismissed.’

It is worth noting that the exclusion clause in this case was in bold and read:

‘Notwithstanding any other Article of this (subcontract) (YDRML) shall not be liable for any indirect, economic or consequential loss whatsoever.’

This can be contrasted with the clause under consideration in the Peerless case, which provided ‘As a matter of policy, Environmental Systems does not accept Liquidated Damages or Consequential Loss…..’.

Another key aspect which emerged is that ‘consequential loss’ must always be read in the context in which the term arises. Bleby J’s conclusion was made in light of YDRML’s exposure
to the exclusive remedies of Liquidated Damages and reimbursement of Performance Guarantee Payments.

The first mentioned point had also been made clear by Master Sanderson in Valentine Estate Pty Ltd v SMEC Australia Pty Ltd [2010] WASC 319, in which the Master said:

‘The phrase ‘indirect, consequential and special losses’ is not a term of art. It has no fixed meaning. The meaning of the phrase depends on the intention of the parties in the particular circumstances, as determined by the contract in which the phrase is used. The contract must be read as a whole and considered in light of admissible background material’: see MGC Properties Pty Ltd v Tang (2009) QSC 322 (23) - (25) (Douglas J).

That same case on appeal (SMEC Australia Pty Ltd v Valentine Falls Estate Pty Ltd [2011] WASCA 138) suggests that the interpretation of such a clause in a particular factual matrix is unlikely to be considered as an appropriate matter to be determined summarily.

When considering the context in which the words ‘consequential loss’ appear, the case of MGC Properties (referred to above) made a distinction between the appearance of those words in what it referred to as ‘an exemption clause’ (noting the provision of such a clause in the Peerless case; together with guarantees, penalties and limited warranties), as opposed to those words being construed in the context of a provision in an indemnity.

In that case, the Judge accepted the submission that there was ‘no good reason’ to limit the losses indemnified to ancillary losses rather than the central loss applying from the default by the principal debtor, and in doing so noted that ‘the loss covered is consequential upon the default of the debtor in the performance of its obligations ... (which) ... must include ... the loss suffered by non-payment of the guaranteed money’s.’

The most recent relevant authority is the decision of Martin J in Regional Power Corporation v Pacific Hydro Group Two Pty Ltd (No. 2) [2013] WASC 356.

In that case, Regional Power claimed Pacific Hydro’s failure to operate the power station was a breach of the agreement and sought damages for the cost of sourcing alternative power that it was contractually obliged to supply. In response, Pacific Hydro argued the claimed losses were ‘indirect’ or ‘consequential’ and therefore it was not liable under the agreement.

The Judge held that the losses were ‘direct losses’ and allowed their recovery.

It has been observed by commentators that the reasoning is significant, as in confining the definition of ‘consequential loss’ in Peerless to the facts of that case, the Court effectively confirmed that the meaning of ‘consequential loss’ had to be determined on a case by case basis.

Relevantly, the clause under consideration in that case read:

‘Neither ...[party]... shall be liable to the other party in contract, tort, warranty, strict liability, or any other legal theory for any indirect, consequential, incidental, putative or exemplary damages or loss of profits’.

It was noted by the Judge [at 51] that: ‘The defendants particularly invoke and seek protection from the force of the words ‘indirect’ and ‘consequential’ ....to ground their conceptual resistance to the plaintiff’s claimed economic damages’.

The damages sought by the plaintiff, which included the costs of hiring diesel generators to generate replacement electricity as well as costs of diesel fuel, travel, accommodation etc, were referred to by the Judge [at 114] as ‘economic losses or damages’ [it should be noted that there was no proscription in that case against the recovery of ‘economic loss or damage’, but rather a specific proscription against recovery of ‘loss of profit’, the Judge noting [at 75] that these are ‘....of a genre loss or damage expressly addressed and excluded under ...[the clause]...’]

Elsewhere his Honour observed [at 58] ‘Arguably if Hadley v Baxendale were to be decided in 2013 instead of 1854, the plaintiff may well have succeeded in showing its claim for loss of profits as being within the first limb of that test, that is, damages arising in the ordinary course’.

Then [at 92], when commenting upon Peerless, his Honour noted that the observations [from the decision] ‘... do not explicitly identify what is a ‘normal measure of damages’. Nor would they explain why, as the sentence...seems to suggest, ‘profits lost or expenses incurred through breach’ must invariably fall outside the scope of a ‘normal measure of damages’.

And then [at 96]: ‘To reject ....the Hadley v Baxendale dichotomy as to remoteness of loss,
only to then replace that approach by a rigid touchstone of the 'normal measure of damages' and which always automatically eliminates profits lost and expenses incurred, would pose equivalent conceptual difficulties.'

The Judge made a number of salient observations about the clause under consideration that appeared to inform his thinking.

Firstly, his Honour noted that the clause was to be assessed as a limiting clause, rather than a clause of complete exclusion, his Honour noting [at 81] ‘Direct losses for breach of the ... [contract] ...are obviously not excluded by its terms’.

His Honour then noted that the limitation against liability had been assembled on a ‘mutual basis’, rather than unilaterally favouring one party over the other, and accordingly there was potential on a case by case basis for limitation outcomes benefiting either side, depending on the presenting circumstances of an asserted contractual breach.

The separation of the words ‘consequential’ and ‘incidental’ was thought to be relevant by his Honour, such that the clause not only limited liability for indirect losses but also for ‘consequential losses’ [at 99] and was to be read [at 81] as ‘indirect or consequential damages’ or ‘indirect or consequential loss’ [his Honour not expressing a view as to whether there was, in fact, a distinction].

His Honour also thought that a number of features of the clause demonstrated its ‘discernible width’, including the use of the word ‘any’ to preface what followed to the end of the sentence within the clause.

In reaching his ultimate conclusion [that the plaintiff suffered ‘direct’ loss], his Honour identified assistance he had taken from the approach of Ryan J in GEC Alstom Australia Ltd v City of Sunshine (No. BC 9600288), 20 February 1996, in which his Honour had said [at 53 – 55]:

‘In reply, Sunshine has submitted that direct losses are limited to items of expense to the extent that they exceed actual income no element of profit is recoverable....”. .... I have concluded that I should not give the phrase ‘direct loss’ the narrow construction suggested by Sunshine. Rather I regard the indemnity clause in its context [authors note : note the possible relevance of this comment being made in respect of an indemnity clause rather than a limiting provision] as sufficient to provide an indemnity ... In respect of damage directly flowing from the breach of the obligation and as wide enough to include lost revenue.....I do not regard loss of revenue as consequential loss.....the term ‘Consequential Loss’ connotes a loss at a step removed from the transaction and it’s immediate effects.’

Martin J then went on to say [at 113]:

‘Equally, I do not assess ..... [the claimed expenditures] ...as being ‘consequential’. At its widest, the word ‘consequential’ might always be read as somehow responsive to something, and thereby encapsulating almost every economic outlay, following upon a breach.....but that is not a sensible meaning to attribute to the word ‘consequential’ when used in...[the limitation clause]....in overall context.’

And [at 114]:

‘In the end, the character of the economic losses or damages claimed here by the plaintiff are properly assessed as direct in nature.’

**Principles to be derived from the decisions**

Clauses such as those considered above are either exclusory in nature or are a limitation clause (in terms of placing limits on categories of loss which are recoverable). Before any clause will be found to have taken away a parties right to damages for breach of contract, it will have to be clear that this is its intent.

Many of the cases referenced do not consider a definition of ‘Consequential Loss’ but rather the meaning and effect of the term in a clause more broadly under consideration. Accordingly, while cases that consider the term in isolation will be relevant in seeking to discern the meaning of that term, where the definition of ‘consequential loss’ extends to a number of other categories of loss, each will have to be separately considered for its meaning and effect.

The law in this area is, however, clearly now attendant with some uncertainty in view of there being recent superior court decisions in three different States that appear to have embraced somewhat differing approaches.

As has been observed, there does not, with respect, seem to be a reason why ‘profits lost or expenses occurred through breach’ might not, in certain circumstances, amount to ‘normal loss’, notwithstanding the seemingly pronouncement to
the contrary by the Victorian Court of Appeal in the Peerless case.

Two cases referred to in Pacific Hydro, which influenced Martin J in arriving at his decision that direct losses in the contemplation of the parties at the time of entry into the contract were not excluded by the ‘indirect, consequential loss or damages’ clause, were concerned with the meaning of the term ‘consequential loss’ in the context of an indemnity provision, rather than an exclusory or limiting provision. The author would query whether the differing context means differing considerations should, in fact, apply.

It should be noted that the Judge in the Alstom case essentially concluded that the expression ‘indirect or consequential loss’ meant [in the circumstances of that contract; i.e. other than those giving rise to the payment of liquidated damages and reimbursement of performance guarantee payments]:

‘...any loss consequential or following, immediate or eventual, flowing from a breach of contract’ [at 290] and was therefore excluded from coverage.

There seems to be little support for that notion in the judgment of Martin J in Pacific Hydro, where his Honour, while noting that possible construction stated [at 113]:

‘But that is not a sensible meaning to be attributed to the word ‘Consequential’ when used within ... [the limitation clause] ... in an overall context.’

The author respectfully prefers that latter view and considers that this approach is more likely to find support going forward.

The expression not considered in the context of the limitation clause in Pacific Hydro was ‘economic’ in the sense of economic loss or economic damage. Martin J did however [at 114] seem to characterise the losses sought to be recovered by the plaintiff in that case as being ‘economic losses or damages’.

It is not entirely clear whether his Honour in doing so was merely adopting the characterisation promulgated by the plaintiff and defendant.

For example, earlier at paragraph 52 of the judgment it is said: ‘The defendants contend the plaintiff’s para 21 economic loss damages as pursued must properly be characterised as ‘indirect’ or ‘consequential’ damages [or loss].’

The expression ‘economic loss’ was however considered in the Alstom case, with potentially startling consequences, given that his Honour took the view that all of the claims by Alstom, including its claims for breach of contract, including delay costs and additional costs allegedly incurred by Alstom were ‘economic’ in nature and that therefore those claims could not succeed in light of the exclusion clause and had to be dismissed [at 315].

This seems to be contrary to the approach taken by Martin J in Pacific Hydro (albeit in the context of a clause containing the expression ‘indirect, consequential loss and damage’ rather than ‘economic loss or damage’) and if it were to arise for consideration in the context of a definition of ‘Consequential Loss’, would reflect an outcome not ordinarily thought to be the result of a clause (and definition) styled in that manner.

It also seems to the author that the reference to ‘economic loss’ when considered in the context of a clause that specifically refers to tortious liability, may just as readily be construed and understood as a reference to [pure] economic loss.

1 Darlington Futures Ltd v Delco Australia Pty Ltd [1986], 161 CLR 500 [510].

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