Direct and consequential losses

A single International approach and understanding?

Determining the losses which arise, and are recoverable, as a result of a breach of contract is of paramount importance. Although certain jurisdictions across the globe have adopted the same starting point in determining what losses may be recoverable, differences exist in relation to the interpretation of losses which arise naturally as a result of a breach of contract, and losses which arise as a result of a special circumstance.

In this case, the English Court of Appeal said that losses/damages which flow from a breach of contract fall into two categories:

- Those which arise as a direct and natural result of a breach, and in the “ordinary course” of events (the first limb, commonly referred to as ‘direct’ losses); and
- Those which arise as a result of a special circumstance of the case (the second limb, commonly referred to as ‘indirect’ losses).

In establishing these categories, the English Court of Appeal held that a party that has breached its contract should be liable for losses within the first limb, as they will have been reasonably foreseeable. However, liability for losses within the second limb only arises if the innocent party can demonstrate that these losses were in the contemplation of the parties at the time of entering into the contract.

‘Remoteness of Damage’ – the rule in Hadley v Baxendale

To establish an entitlement to damages arising from another party’s breach of contract, a party must demonstrate that the loss sustained:

- Was, as a matter of fact, caused by the other party’s breach of contract; and
- Is not too remote. This means demonstrating that, as a matter of law, it is properly attributable to the party that breached the contract.

In order to demonstrate that a loss is not too remote, a party must establish that the loss was foreseeable. The case which sets out the traditional test for establishing whether a category of loss or damage is foreseeable is the English case of Hadley v Baxendale¹.

Recent changes in the approach of various common law jurisdictions have reinforced the need for parties to closely consider, identify, and define the losses that may arise as a result of any breach of contract, and how the determination of liability for such losses is best approached.

In Hadley v Baxendale was decided in 1854. In 1894, in the case of Primrose v Western Union Tel Co², the US Supreme Court confirmed that Hadley v Baxendale was the ‘leading case on both sides of the Atlantic’, and it has since been accepted as the leading authority in the majority of states within the US. Similarly, Australian and New Zealand courts have also consistently followed Hadley v Baxendale and the line of English authorities which flow from that decision.

¹ [1854] 9 Ex 341
² 154 US 1 (1894)
Defining and Identifying ‘Direct’, ‘Indirect’ and ‘Consequential’ Loss

Whilst the theory of the ‘remoteness of damage’ test appears relatively straightforward, assessing whether a loss is ‘direct’ or ‘indirect’ is, in practice, a different matter.

Confusion also arises as a result of the use of alternative terminology, in particular the term ‘consequential loss’, which is used as both an alternative, and in addition, to ‘indirect’ loss. For example, clause 17.6 of the FIDIC Silver Book provides the following exclusion:

“Neither Party shall be liable to the other Party for loss of use of any Works, loss of profit, loss of any contract or for any indirect or consequential loss or damage which may be suffered by the other Party in connection with the Contract....”

As to determining what is meant by ‘consequential loss’, it was English law that led the way in determining when, in 1978, the English Court of Appeal decided the case of Croudace Construction Ltd v Cawoods Concrete Products Ltd. In this case, the court was required to decide upon a clause which provided:

“We are not under any circumstances to be liable for any consequential loss or damage caused or arising by reason of late supply or any fault, failure or defect in any material or goods supplied by us....”

In reaching its decision, the court held that the reference to ‘consequential loss’ meant loss recoverable under the second limb of Hadley v Baxendale – i.e. that it is recoverable if it could reasonably be supposed to have been in the parties’ contemplation at the time of the contract’s formation. It did not extend to loss under the first limb of Hadley v Baxendale, and did not encompass losses which arose as a direct and natural result of a breach.

Accordingly, under the principle laid down in Croudace Construction, FIDIC’s use of the words “any indirect or consequential loss or damage” does not add anything further to the protection that has already been provided conferred by the Hadley v Baxendale remoteness of damage test.

In terms of the identification of losses that are ‘direct’ or ‘indirect’/consequential’, practical misunderstandings and/or misconceptions with regard to the types of losses that fall within each category have existed for a long time. A common misconception is that the first limb of Hadley v Baxendale is limited to physical damage, or in construction and engineering terms, the cost of rectifying a defect. Equally, parties often believe that certain types of loss (such as loss of profit and/or revenue) automatically fall within the ‘indirect’/consequential’ category. Such misconceptions are dangerous.

Ultimately, the categorisation of losses depends upon the facts and circumstances pertaining to each contract, and whether ‘indirect’/consequential’ losses can be demonstrated to have been in the contemplation of the parties at the time of entering into the contract. Taking loss of profits and/or revenue as an example, the following examples illustrate that the English court’s view is that loss of profits and/or revenue will, to a certain extent, fall within the first limb of Hadley v Baxendale:

- Victoria Laundry Ltd v Newman Industries Ltd\(^4\) - in this case, Newman was five months late in delivering a boiler to the laundry. This caused Victoria to lose a lucrative contract with the government, and Victoria sued for all profits that were lost as a result of Newman’s breach. It was held that Victoria could recover its ordinary loss of profits, but not those which would have resulted from the government contract. These would only have been recoverable if Newman knew, or could have reasonably been expected to know, about the government contract at the time of entering into the contract.
McCain Foods (GB) Ltd v Eco-Tec (Europe) Ltd - in this case, McCain had bought a system to enable it to generate heat and electricity in a combined heat and power plant. McCain intended to use the electricity for its own purposes and to sell Certificates of Renewable Energy Production to third parties. Eco-Tec’s system was defective, and McCain’s claim for damages included a claim for its loss of revenue. This was awarded on the basis that, had Eco-Tec’s system operated correctly, it would have resulted in revenue for McCain through the sale of the renewable energy certificate to third parties. This was therefore a natural and direct loss.

In terms of how the English court’s examples have been followed in other common law jurisdictions, although the US courts accepted Hadley v Baxendale as the leading authority, their application of the remoteness of damage test was much more restrictive. Loss of profit and/or loss of revenue was generally accepted to be an ‘indirect’ or ‘consequential’ loss, which was only recoverable in special circumstances. At the opposite side of the globe, however, the Australian and New Zealand courts followed the English approach and considered that loss of profit and/or loss of revenue could, depending on the circumstances, be a ‘direct’ loss.

Recent developments

The different approaches of the English, US, Australian and New Zealand courts to the identification of ‘direct’ or ‘indirect’/’consequential’ losses have served to demonstrate that there is no universal legal ‘rule’ which attributes types of loss to each category/term.

That said, the fact that each of the jurisdictions generally took a consistent approach with regard to the interpretation and identification of ‘direct’ or ‘indirect’/’consequential’ losses meant that there was, to some degree, an element of certainty within each. However, and although recent decisions in the English courts have maintained the Croudace Construction approach, the US, Australian and New Zealand courts appear to have realigned or shifted their positions.

In the US, the recent case of Biotronik A.G. v Conor

Medsystems Ireland Ltd appears to represent a realignment towards the English Court’s position on losses that are ‘direct’, and losses that are ‘consequential’. In this case, the New York Court of Appeals held that loss of profits could constitute general (direct) damages as they were clearly a “direct and probable result of a breach”. They therefore did not fall within the definition of “consequential damages”, which were exempted under the contract.

However, in Australia and New Zealand, the courts have been seen to have moved away from the traditional Hadley v Baxendale approach. In the 2008 case of Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd the Victorian Court of Appeal held that consequential loss should no longer be strictly interpreted as the second limb of Hadley v Baxendale, and should be considered as:

“anything beyond the normal measure, such as profits lost or expenses incurred through breach”.

The practical effect of the Peerless decision is that it extends the categories of losses which could fall within the second limb of Hadley v Baxendale. This approach found favour in Oceania Furniture Ltd v Debonaire Products Ltd in which the High Court in Wellington held that losses such as loss of opportunity, and loss of profits due to loss of reputation, were all consequential as opposed to direct losses.

The Peerless approach was, however, extended further by the case of Alstom Ltd v Yokogawa Australia Pty Ltd & Anor. In this case, the Supreme Court of Southern Australia held that the English Court’s approach to the interpretation of ‘consequential loss’ was too restrictive. In adopting a dictionary definition, the court concluded that, unless qualified by its context, the term ‘consequential loss’ extended to cover “all damages suffered as a consequence of a breach of contract.” The practical effect of this conclusion was that, in this case, apart from specified liquidated damages, any and all other losses were consequential, and excluded by a term of the contract which merely referred to “indirect, economic, or consequential loss”.

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5  [2011] EWHC 66 (TCC)
6  See, for example British Sugar v NEI Power Projects [1998] 87 BLR 42, Hotel Services Ltd v Hilton International Hotels (UK) Ltd [2000] 1 All ER (Comm) 750
7  2014 WL 1237154 (N.Y. Mar. 27, 2014)
8  (2008) 19 VR 358; [2008] VCSA 26
9  [2009] NZHC 1139
10  [2012] SASC 49
Protecting against Uncertainty

Looking again at examples such as clause 17.6 of the FIDIC Silver Book, the approach taken by the Australian and New Zealand courts is likely to result in an entirely different interpretation of the words “any indirect or consequential loss or damage” than that of the English court. In an international context, this wider approach is undoubtedly more preferable to parties, as it provides reassurance that the term ‘consequential loss’ gives some degree of additional (and all-encompassing) protection against the losses for which they will be liable. There is no doubt that the English law approach can lead to uncertainty and inconsistency.

However, unless and until a consistent approach is adopted across all common-law jurisdictions, it remains paramount that parties contracting on major international projects understand the principles which will underpin their liability, and the law governing the contract. There remains no general legal rule of what ‘direct’ loss and ‘indirect’/‘consequential’ loss means, and upon which parties can rely upon in order to import a clear and consistent definition or understanding into their contracts. What will ultimately determine whether a loss is ‘direct’ or ‘indirect’/‘consequential’ loss is the context of the contract in question. It is also important to be aware that, in common law jurisdictions this is a developing area of law, and new case law may impact upon the current interpretation of these terms (and the exclusion clauses in which they appear).

In the circumstances, parties contracting on major international projects should, at the very least:

• closely consider their understanding and/or preconceptions of what each term means in the context of their project; and
• consider, identify, and define the types of loss that they are (or are not) prepared to accept liability for.

As a point of practice, and when drafting any exclusion clauses, parties should not merely rely upon the use of generic definitions such as ‘direct’ or ‘indirect’/‘consequential’. Rather, they should clearly and specifically detail the categories of losses that they will not be liable for in the event of any breach of contract – even if that means amending a standard form contract such as FIDIC or their own standard terms and conditions.