The Basics of English Law for Contractors

Direct and Indirect Loss

This newsletter will summarise the difference between direct and indirect loss (sometimes called "consequential loss") resulting from breach of contract and the issues to be aware of when attempting to exclude liability under a contract for direct and indirect loss. Please note that we have not covered other aspects of recoverability of damages, such as causation and mitigation, in this newsletter but will explore them in future editions.

"Remoteness of damages" – the basic test

Under English law, a party to a contract cannot recover all losses. The party in breach will not be liable for losses that are too "remote". By this we mean that even if it is shown that his breach caused a loss, if that loss was sufficiently unusual or unlikely then he will not usually be liable for it, unless he was aware of some special or unusual circumstances when he entered into the contract. The test for "remoteness" was laid down in the case of Hadley v Baxendale. Under the test, a person who breaches a contract is generally liable for two types of loss:

(i) Loss that arises naturally, i.e. according to the usual course of things from the breach. This is the first limb of the remoteness test and is concerned with what a reasonable man should know to be the "usual course of things" or "ordinary circumstances". Loss falling under this first limb is referred to by the courts as "direct" loss; or

(ii) Loss that does not arise naturally but that "may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach". This is the second limb of the test and is concerned with knowledge of special circumstances outside the usual course of things and what loss could have reasonably been contemplated by the party in breach with knowledge of the special circumstances. Loss falling under the second limb is referred to by the courts as "indirect" or "consequential" loss.

Any loss which is more "remote" than (i) and (ii) above is considered to be too remote and a party will not generally be liable for it. As regards direct and indirect loss, although the default position is that a party will be liable for both, it is not uncommon for parties to a contract to exclude liability for indirect loss and certain types of direct loss.

Limitation of damages in practice

Most contracts deal with the principle that a party cannot recover all losses by imposing a limit on liability. For example, FIDIC Clause 17.6 states that:

"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 (…)"

So, what types of loss can be recovered by Contractors under the FIDIC contracts? Contractors often wish to recover the following items:

- direct loss and expense
- preliminaries
- overheads
- loss of productivity/disruption
- profit
- interest
- finance charges
- inflation/exchange rate fluctuation
- claims preparation costs
- lost commercial opportunity and business interruption

Only some of these are recoverable under the FIDIC contracts:

- direct loss and expense – if they fall within the definition of "Cost" ("all expenditure reasonably incurred (or to be incurred) by the Contractor, whether on or off the Site, including overhead and similar charges, but [not including] profit ") and are directly linked to the clause giving rise to the claim, they can be claimed.
- preliminaries – as above, these are also recoverable.
- overheads – also recoverable; the cost of running the business, as distinct from general site costs, is expressly allowed for in the definition of Cost.
- loss of productivity/disruption – in principle this is recoverable but in practice proving this loss is difficult. The "measured mile" approach compares work in disrupted and undisrupted conditions with the difference between the two being the disruption factor.
- profit – this is not recoverable, unless expressly allowed for in the Contract. Profit is excluded from both the definition of Cost and by Clause 17.6.
• interest – recoverable; the Contractor has an express right to interest on any unpaid sums under the standard FIDIC forms.

• finance charges – recoverable; under English law, it is possible to claim finance charges as part of a claim for direct loss and expense.

• inflation/exchange rate fluctuation – not recoverable; increased costs resulting from inflation/exchange rate fluctuation are classed as “consequential loss” and are therefore excluded by Clause 17.6.

• claims preparation costs – may be recoverable; under English law can be recoverable in principle but it is hard to establish such claims.

• lost commercial opportunity and business interruption – generally not recoverable.

Drafting tips for exclusion clauses

When drafting an exclusion clause, which sets out the types of loss for which a party is not accepting liability under a contract, you need to be very careful to ensure that the clause captures accurately the type of loss that you intend to exclude.

As we have seen, the FIDIC exclusion clause expressly excludes “loss of profit”. In addition, it excludes indirect and consequential loss. A mistake people have often made, as we can see from various English court judgments, is to think that profit is always indirect loss (the second type of loss in the Hadley v Baxendale test) and that therefore loss of profit will be excluded by a clause that excludes indirect (or “consequential”) loss.

The English courts have held that loss of profit can sometimes be a direct loss. If your clause only excludes indirect (or consequential) loss you will still be liable for any loss of profit that is direct loss – the first type of loss in Hadley v Baxendale. Examples include the case of British Sugar v NEI Power Projects Ltd¹ where a claim for increased production costs and loss of profits caused by defective electrical equipment was found to be direct loss and Deepak v ICI² where a claim for wasted overheads and loss of profits caused when a chemical plant was destroyed by defective design technology was direct loss.

1 [1998] 87 BLR 42
2 [1999] 1 Lloyd’s Rep 387
3 [2000] BLR 218
4 [2008] EWHC 225
5 [2010] EWCA Civ 912

In Pegler Ltd v Wang (UK) Ltd⁴ the court considered the following clause:

“[The defendant] shall not in any event be liable for any indirect, special or consequential loss, howsoever arising (including but not limited to loss of anticipated profits or of data) [...]”

The court held that this clause did not exclude liability for all loss of profits, but only for loss of profits of an indirect or consequential kind. As the claim was for direct loss of profit, the clause did not protect the defendant.

Be careful about using words like “other” and “including” which can limit the scope of the exclusion clause.

In Ferryways NV v Associated British Ports⁵ the exclusion clause was worded as follows:

“[The defendant] shall have no liability to the Customer (...) for any loss, damage, costs or expenses of any nature (...) which is of an indirect or consequential nature including without limitation the following: (i) loss or deferment of profit (...)”

The court held that by using the words “including without limitation” the parties were identifying the type of loss that could fall within the exemption clause so long as it met the prior requirement that the loss was “of an indirect or consequential nature”. As such, losses of profit of a direct nature were not excluded.

It is not enough however just to cover both direct and indirect loss of profits in your clause. You need to consider in advance the different types of loss for which you are and are not accepting liability and to draft the contract clearly and precisely to reflect this. The recent case of GB Gas v Accenture⁶ is relevant in illustrating this point. Although the exclusion clause excluded liability for loss of profits and also for indirect losses, when the court analysed the specific losses claimed by GB Gas (such as compensation paid to customers and additional borrowing charges incurred) it found that these were neither losses of profits nor indirect profits. They were therefore not covered by the exclusion clause and were recoverable by GB Gas. Accenture would have needed to include more specific wording in order successfully to exclude the types of loss claimed.

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Should you have any questions please contact Jonathan French (jonathan.french@pinsentmasons.com) or your usual Pinsent Masons adviser who will be able to assist you further.

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