Indirect loss – a discussion note

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Setting the scene

Limitation clauses typically exclude the supplier's liability for indirect loss arising from breach of contract. It is so common that it is often not remarked upon or queried. Should the customer accept the exclusion and does the exclusion bring any significant benefit for the supplier?

Hadley v Baxendale - what is a recoverable loss?

In May 1854, a Gloucester flour mill had a broken crankshaft. They had no spare and, without the crankshaft, the mill could not function. The mill owners went to a common carrier operating under the name of Pickfords & Co and engaged them to take the broken crankshaft to Greenwich for repair. Pickfords promised overnight delivery but in fact did not manage to deliver the broken crankshaft for five days. The mill owner claimed that the delay had lost them five days' business and claimed damages. The case was reported as Hadley v Baxendale[1]. The court defined the circumstances in which damages may be recoverable for breach of contract. Damages for breach of contract can be recovered either: (1) if the loss could fairly and reasonably be considered to arise naturally ("according to the usual course of things") from the breach; or, (2) if the loss could reasonably be supposed to have been in the contemplation of both parties at the time at which the contract was made.

This rule still applies. Damages for breach of contract are recoverable if they fall within the first limb of the rule (ie loss that flows naturally from the breach) or the second limb of the rule (ie loss that the parties knew, or can reasonably be supposed to have known, at the time of the contract, was likely to flow from a breach).

The first limb: the meaning of "not unlikely"

In 1967, the case of the Heron II reached the House of Lords[2]. The Heron II was a ship chartered to carry sugar to Basra. The ship took an unauthorised detour and so breached the terms of the contract with the result that the cargo of sugar arrived later than planned. By the time the sugar reached the Basra market, the price had fallen significantly. The merchant claimed the loss due to the difference in price against the ship owner. The owner

[1] 1854 EWHC Exch J70
[2] C Czarnikow Ltd v Koufos (The Heron II) 1967 3 All ER 686

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denied that the fall in the market could be taken into account when calculating damages. The owner knew there was a sugar market in Basra but had not been specifically told that the merchant intended to sell the cargo there. The case went in favour of the merchant. The court held that a loss flows naturally if a reasonable man would have realised that the loss was a "not unlikely" consequence of the breach. "Not unlikely" was taken to mean a less than even chance but something that was still not unusual and was easily foreseeable[3].

The second limb: assumption of risk?

More recently, the House of Lords added a bit of uncertainty to the second limb. In Transfield Shipping Inc v Mercator Shipping Inc[4], a ship was returned from a charter 9 days late. The delay meant that the ship was not available to start its next charter as planned and it had to be cancelled. This subsequent charter was long term (191 days) and lucrative and the owner lost the fee. In the meantime, the market fell, amplifying the owner's loss – he could only re-charter the ship at a lower rate.

The Court of Appeal found for the owner. The loss of the 191 day charter as a result of the delay was foreseeable and readily within the parties' contemplation, especially given the volatile nature of the market.

The House of Lords reversed this judgment and only allowed the owner to recover damages for the actual period of the delay (ie 9 days). The Lords clearly felt that something more than simple contemplation of the possibility of loss was required for the defendant to be held responsible but the judgments do not make it clear what that extra something actually is. Some suggest that responsibility for a particular loss needs to be assumed if it is to be recoverable, others that the extreme volatility of the market meant that the actual loss was not in the parties' reasonable contemplation. Unfortunately, the question has been left hanging and we can only wait for clarification.

What is the justification for excluding indirect loss?

Direct loss is loss falling within the first limb of the Hadley v Baxendale test. Indirect loss is loss that falls within the second limb. Typically, a limitation clause in a contract will exclude responsibility for indirect loss. There are two arguments regularly relied on to justify this but each has its weaknesses.

The first justification - remoteness

The first argument is that indirect losses by definition are remote and are too remote and too speculative to be laid at the defendant's door.

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[3] C Czarnikow Ltd v Koufos (The Heron II) 1967 3 All ER 686 at 690
[4] Transfield Shipping Inc v Mercator Shipping Inc (The Achilleas) 2008 2 All ER (Comm) 753

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This may well be true. But does adding an exclusion of liability for indirect loss strengthen the defendant's position? The claimant still has to show that the defendant is in breach of contract, that the breach has caused the relevant loss, that the loss is not too remote and can be accurately quantified, that the loss is not the claimant's own fault and that the claimant has taken steps to mitigate the loss suffered. In that context, it is clear that the claimant will have to work hard to prove that the defendant should be responsible for indirect losses. Yes, adding the exclusion adds an extra hurdle for the claimant in that the claimant will have to show that the exclusion is not enforceable but it is questionable whether this represents a significant improvement in the defendant's position.

Separately, it is often difficult to assess in advance what will amount to indirect loss and the cases suggest that there is an element of judicial discretion involved. The second limb of the Hadley v Baxendale test is not a model of clarity or predictability, even allowing for the refinements offered by the House of Lords in the Heron II. Some interpretation may be required. Although the Heron II is generally accepted as concluding that loss flows naturally if it is a not unlikely consequence of the breach, their Lordships' judgments discuss a range of phrases: "not unlikely", "not unlikely to occur", "liable to result", "a real danger" and "a serious possibility". Four out of the five Law Lords did agree that "on the cards" was an ill-defined colloquialism and should not be used but otherwise there was little in the way of unanimity.

Subsequent cases have muddied the waters further: in the light of the Transfield decision, will a claimant be able to recover losses where the defendant cannot be said to have assumed responsibility for those losses even though they were "not unlikely"?

Court decisions around indirect loss involve an element of judicial discretion. Indirect loss is not merely speculative but also unpredictable and lawyers can be reluctant to advise a client to accept an unquantified and unidentified risk. But, the fact that indirect loss is speculative and unpredictable does not mean that indirect loss will always be recoverable by the claimant. The claimant will only succeed in their claim if they can prove breach and causation, overcome the hurdle of remoteness and show that they have taken adequate steps to mitigate their loss. The more unexpected a loss is, the safer the defendant is likely to be.

Of course, if the potential loss has been discussed during the negotiations, then it may be seen as being within the reasonable contemplation of the parties. If so then, under the second limb of the Hadley v Baxendale test, it is more likely that the defendant will have to pay up. If a risk has been brought to a party's attention and the potential losses discussed, it is harder to argue against excluding them. The parties have had the opportunity to decide how to apportion the risk by way of specific contract provisions or insurance or by taking precautions in performing the contract. The defendant is, after all, in breach of contract and has caused the claimant loss.

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The second justification – allocation of risk

The second argument used is that the loss has only arisen because of a set of special circumstances that were not factored into the price. Therefore, if the defendant is held liable, the defendant is in effect being made to bear a disproportionate degree of the risk.

This argument works well where the customer is buying a standard product or service and paying a standard fee.

It does not work so well where the customer has negotiated a bespoke deal. The parties have had ample opportunity to allocate the risk between themselves and it is hard to see why the defendant should be able to turn to the courts to help him escape his responsibilities. Again, the defendant is not left unduly exposed. He has the practical comfort that the claimant will have to prove breach and causation, to overcome the hurdle of remoteness and to show that he has taken adequate steps to mitigate his loss.

Conclusions - is it vital to exclude indirect loss?

It is always preferable to reduce exposure to risk. The best course must always be to exclude liability for indirect loss, if only on the basis that the more loss you can exclude, the more of an uphill struggle the claimant will have.

But, pragmatically, it is not the end of the world if indirect loss cannot be excluded. The justifications that are regularly used are not absolute and there will be circumstances when they are not appropriate.

If one party objects to the exclusion of indirect loss, they may have a specific concern in mind. It may well be better (for both parties) if this concern is aired and addressed during the negotiations. The approach does risk raising issues that the defendant might otherwise have been unaware of – and so it risks bringing the second limb into play. But it also brings clarity and, more importantly, it allows the parties the opportunity to apportion or mitigate the risk. The risk may be one that can easily be controlled by one party. Or it may be that it can be addressed by adjusting the contract price or by obtaining insurance.

In the last resort, any claimant has significant obstacles to overcome before they can enforce a claim for indirect loss. Seen in that context, accepting liability for indirect loss becomes a calculated risk that may be justifiable.

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