Direct or Indirect Loss?

Introduction

Construction contracts often contain a provision excluding liability for indirect and consequential loss, but the distinction between direct loss and indirect/consequential loss can be a confusing one. In addition, contractual exclusions of indirect loss do not always offer the protections that contractors might think they do. A recent case from the English Technology and Construction Court illustrates some of the problems and provides useful lessons for limiting a contractor's liability.

Direct and indirect losses

The classic case of Hadley v Baxendale as interpreted by a number of subsequent cases, categorises the distinction between direct and indirect loss as follows.

Direct loss is loss arising naturally, according to the usual course of things, from the breach of contract itself, and is therefore foreseeable and recoverable.

Indirect loss is loss that arises from a special circumstance of the case and is recoverable if it may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract, as the probable consequence of the breach. In other words, if the party in breach of contract was aware of the special circumstances of the other party when the contract was entered into, the losses may be recoverable.

This distinction has been considered again in the 2011 case of McCain Foods (GB) Ltd v Eco-Tec (Europe) Ltd.

The McCain Case

In McCain, the purchaser had bought a system ("System") for removing hydrogen sulphide from the biogas produced by its waste water system, so that the biogas could be used to generate heat and electricity in a combined heat and power plant. In addition to using the electricity for its own purposes, the purchaser intended to generate revenue by selling Certificates of Renewable Energy Production to third parties. However, the System was found to be defective and McCain claimed damages from the supplier. The damages claim included:

- the cost of buying a replacement system;
- loss of revenue from the System (from selling Certificates of Renewable Energy Production);
- the extra cost of buying electricity (since the purchaser could not generate its own);
- the cost of contractors and other personnel;
- the cost of mitigation efforts; and
- various other smaller claims, including the cost of staff time to resolve the issues.

The Court held that the supplier had breached its obligation to provide a System that was fit for its intended purpose, so the issue arose of which losses were recoverable. Although the supplier accepted liability for the cost of replacing the System, which it agreed was a direct loss, it contended that all the other losses were indirect losses.

The contract stated that "in no event however will Seller be responsible for indirect, special, incidental and consequential damages". As a result, the supplier argued that it was not liable for McCain’s losses other than the cost of replacement equipment.

1. Hadley v Baxendale (1854) 9 EX 341.
The Court, however, disagreed, holding that all the losses, including the loss of revenue, were direct losses in the circumstances and were therefore recoverable.

The reasoning in McCain

In considering whether loss of revenue was a direct or an indirect/consequential loss, the Court referred to the case of Hotel Services Ltd v Hilton International Ltd. In that case, the Court found that a contractor had supplied hotel mini bars that were unusable and dangerous, in breach of contract. The Court held that the natural and immediate loss was the cost of neutralizing the danger and the profit that the hotel would have realized through the use of the minibars. As a result, the loss of profit was held to be a direct loss arising naturally from the breach of the contract. It should be noted that the loss of profit was restricted to the profits that the hotel would have made from the minibars themselves. The Court made clear that any broader loss of profitability of the hotel itself was consequential loss, and in this case was not recoverable.

The McCain Court also considered the judgment in Deepak v ICI. In that case, it was held that loss of profits arising from the destruction of a methanol plant were by definition direct losses arising naturally from the breach of contract. Wasted overheads incurred during the reconstruction of the plant, as well as profits lost during that period, were held to be no more remote than the costs of reconstruction of the methanol plant.

In McCain the Court held that the System would have resulted in revenue has it operated correctly, and that the loss of such revenue was the natural or immediate (and therefore direct) loss caused by the inability to commission the system. Loss of revenue was therefore recoverable from the time when the System should have been commissioned. Similarly, the additional utility costs incurred by McCain were also recoverable as a direct loss for the relevant period that the System ought to have been generating electricity.

The Court also held that the costs of repair, replacement, mitigation and associated losses fell within the ambit of losses arising naturally from the breach and were therefore direct losses and recoverable. Thus, the supplier was liable for the costs of contractors, site managers and health and safety personnel, attempted mitigation, auxiliary equipment and civil works, employee time, third party experts and laboratory testing and the purchase of auxiliary equipment from the Supplier.

Implications and drafting points

This High Court judgment follows a long line of case law showing that an exclusion of indirect losses does not always serve to limit liability in the way that a party might envisage. There is certainly a common misconception that loss of profits and other financial losses will always be consequential losses. The scope of what the courts are willing to consider as direct losses is wide, and contractual parties should therefore give careful consideration to limitation of liability provisions in their contracts.

Often parties will include an exclusion of "indirect and consequential losses" in an attempt to limit the contractor's liability. It is important to note, however, that an exclusion or limitation of "indirect and consequential losses" will not, under English law, serve to exclude loss of profits where that loss is regarded as direct. So, for example, wording that excludes liability for "all special, indirect and consequential losses, including loss of profit..." might exclude liability for indirect loss of profit but is unlikely, under English law, to exclude direct loss of profit. Our May 2009 newsletter ("Excluding liability for consequential loss and loss of profits") considers this issue in more detail.

When negotiating a limitation of liability clause, it is therefore important for contractors to give thought to the kinds of losses that they are seeking to exclude. As clear words are required to exclude categories of loss, we recommend that each category be specifically identified in the exclusion clause. In addition, if the intention is to exclude liability for both direct and indirect losses in each category, then the clause should be drafted to exclude first of all those categories, and then exclude indirect and consequential loss. So for example, the contract could exclude liability for "all loss of
profit, loss of use, loss of revenue, loss of contracts, increased costs and expenses, wasted expenditure [etc] and all special, indirect and consequential losses [...]."

Parties should of course seek legal advice on the specific wording of an exclusion clause.

There are many ways of limiting a contractor’s potential liability under a contract, including agreeing monetary caps (preferably at an insurable level), or setting out specific remedies such as liquidated damages (provided that such remedies are also expressed to be exclusive). An exclusion of loss of profit and other such categories of loss is a helpful addition to the range of options available to the contractor, particularly as the potential amount of such losses on a construction project is inherently uncertain. However, as the McCain case shows, it is essential to ensure that the exclusion is properly drafted in case the loss of profit or other type of loss turns out to be direct loss.