

Limitation of liability: taking an inclusive approach

SLAUGHTER AND MAY

Rob Sumroy, Miles McCarthy and Duncan Blaikie of Slaughter and May consider an alternative approach to limiting liability in commercial contracts.

Lawyers advising on limitations of liability in commercial contracts often rely on concepts and terminology which are not readily understood or applied, either by themselves or, more importantly, by their clients, and which are not necessarily relevant to the commercial risks on that particular deal.

This article considers the problems that can arise from the traditional approach to limiting liability under a contract and, in light of these concerns and recent case law, suggests an alternative approach for lawyers advising on and negotiating limitations of liability.

The traditional approach

The traditional approach when drafting and negotiating commercial contracts is to define liability by exclusion: much time is spent focusing on and identifying those heads of loss for which a party or parties are not to be responsible. The implication is that losses which have not been specifically called out by the parties (or, at least, such losses as are not deemed too remote, or otherwise excluded at law) would be deemed recoverable under the contract.

The fundamental principles on the recovery of contractual damages are set out in *Hadley v Baxendale* ((1854) 9 Exch 341) (see box "The rule in *Hadley v Baxendale*"). Over time, loss contemplated by the first limb of *Hadley* has become known as "direct" loss, while that contemplated by the second limb is known as "indirect" (or consequential) loss. These terms form the bedrock of the traditional exclusion clauses in modern commercial contracts.

There is now a substantial body of case law and academic commentary interpreting the concepts of direct and indirect (or consequential) loss in the context of the exclusion of liability under a contract. All too often, however, lawyers have no real appreciation of what in practice falls to be recovered when these conventional labels are used. This is due in a large part to the fact that the rules of law surrounding the recovery of contractual damages, even if they can be considered settled, are difficult to apply in modern practice with any certainty (see box "A case in point").

If lawyers cannot give to their clients some certainty as to what specific heads of loss or damage would be recoverable under a contract, then they are failing in their fundamental role as advisers.

The rule in *Hadley v Baxendale*

A party may recover damages for breach of contract where that damage is:

- * Such as may fairly and reasonably be considered arising naturally, that is, according to the usual course of things, from such breach of contract itself (the first limb).
- * Such as 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 of it (the second limb).

Subsequent case law has developed this rule, such that the first limb of *Hadley* can be interpreted as loss which a reasonable man would have realised was a "not unlikely" consequence of a breach of the contract (*Czarnikow Ltd v Koufos (The Heron II)* [1969] 1 AC 350).

Relying on standard-form contracts

It is perhaps because of these inherent difficulties in application that lawyers (and, to an even greater extent, their clients) avoid plain English dialogue with the other side on the allocation of risk and the effects of the contractual limitation/exclusion of liability.

Instead, lawyers produce and hold fast to their clients' "internal group standard" or to traditional legal precedents to frame the liability position in the contract, ignoring (or at least placing less emphasis on) the particular commercial drivers and overall risk profile of the deal they are negotiating. For example, in the outsourcing and service procurement industry context, large service providers will often argue that they have a fixed corporate approval process built around the exclusion of certain heads of loss. Deviation from those "standard" risk models is not countenanced.

But not only service providers fall into this trap. Lawyers for customers are guilty of adopting similar "lazy" reasoning in the context of legal precedents: a contract which seeks to exclude indirect or consequential loss may be thought by some lawyers to be "market-standard" and they may take some comfort from the fact that the client is able to recover direct losses.

The difficulty arises, however, when a client seeks an explanation of what is covered by direct loss in light of the commercial facts of that particular deal. In any services-based arrangement where no tangible goods are manufactured or sold (as is increasingly the case in our modern economy), a client may be distressed to find out that certain losses (for example, loss of data, loss of revenue, loss of anticipated savings and regulatory fines) cannot be said with any certainty to fall within the legal classification of direct loss, when these are the risks the client most fears.

By focusing on the negative (what is excluded) in their approach to limiting liability, lawyers are doing a disservice to their clients. Rather than being explicit about what can be recovered, they are exposing their clients to the court's interpretation of the rules on remoteness and the risk of a judgment that may be totally at odds with their client's commercial rationale for entering into the contract (see box "Transfield").

A case in point

In *GB Gas Holdings Ltd v Accenture (UK) Ltd and others*, Accenture contracted with Centrica to provide a new customer billing system for the entire British Gas business ([2009] EWHC 2734 (Comm)). The contract excluded liability for, among other things, any indirect or consequential loss suffered by either party.

Following a purported breach of warranty by Accenture, Centrica claimed for damages which included compensation paid to its customers, additional borrowing by Centrica necessary to finance its business (as a result of a drop in revenue due to incorrect billing) and stationery and correspondence costs resulting from updating customers on the management of particular incidents.

At a preliminary hearing, Accenture argued that such classes of loss fell under the head of indirect loss and were irrecoverable; the judge, however, deemed all such loss to be direct and therefore recoverable under the contract. While a full hearing of the case is expected to take place later in 2010, this interim decision is a timely reminder of the capricious outcomes that can arise when the courts interpret and apply the traditional heads of loss in the context of limitation clauses.

An alternative approach

It is clear that the traditional approach to limiting liability under a contract presents challenges to lawyers and clients alike. The approach set out below incorporates four key principles, which together aim to avoid (or at least mitigate) the current uncertainty surrounding the interpretation and application of limitation clauses.

Reinforce the relevance to the client. During protracted contract negotiations, it is not uncommon for discussions on the limitation clause to trigger a "Blackberry moment": believing this to be arid, futile and irrelevant legal sparring, the client will switch off from the negotiation, take out their Blackberry and use the time to catch up on unread emails.

To avoid this, lawyers should reinforce to their clients the relevance of liability limitations (and risk allocation generally) to the client's overall business case. They should remind clients that the contract in question does not exist in a vacuum: it is part of a supply chain continuum, in which the client receives and provides services under a number of inter-related contracts, each with its own risk profile. If the client fails to adequately back-off its liability in this contract, it clearly runs a risk that it will be exposed under another.

Identify client concerns. Clients should be encouraged to take an active role in determining the content of the limitation clause. Rather than focus on the loss that is to be excluded, the client should clearly identify, in words which describe the commercial reality, those losses which are fundamental to its business case and which it believes should be recoverable in any event. Put simply, the client should ask itself two questions: What loss will I suffer if something goes wrong under the contract? Can I expect to recover some or all of this loss?

Tailor bespoke limitation clause. Once the client has identified the actual losses it hopes to recover under the contract, these should be set out in a separate “inclusion” clause and acknowledged as recoverable in any event (see box “Sample clause”).

An inclusion clause gives the client certainty that it will be able to recover at least some of the loss which it suffers under the contract. It helps avoid the often difficult and time-consuming process of proving that the loss suffered is direct (and therefore recoverable) and provides the counterparty with a clear incentive to perform under the contract.

Transfield

The House of Lords’ decision in *Transfield Shipping Inc v Mercator Shipping Inc* is a good example of the court adopting an unconventional approach to the application of the rules on remoteness of damage ([2008] UKHL 48). The judgment initially excited some debate as to whether it represented a new test for liability (as opposed to being a peculiarity of shipping law).

On a simple view, *Transfield* appears to have extended the remoteness of damage test beyond the two limbs of *Hadley*, overlaying a separate requirement that a party may not be liable even for foreseeable losses if they are not of a type for which that party has (in the words of Lords Hope and Hoffmann) “assumed responsibility”. The Lords went on to say that a party cannot be expected to assume responsibility for something he cannot control and, because he does not know anything about it, cannot quantify.

It can, however, be argued that *Transfield* simply reflects another attempt by the courts to reaffirm and express the fundamental question that lies at the heart of the rule in *Hadley*: in broad terms, what did the parties have in mind when the deal was struck, taking into account both their actual knowledge and the knowledge that a reasonable person would have of the market? It should be remembered that *Hadley* and the cases that followed it concerned, like *Transfield*, the liability that would normally be expected to be assumed by a party in commercial dealings.

A well-drafted inclusion clause can also specifically identify the heads of loss for which a party can be said to have “assumed responsibility”. This will (from an evidential perspective at least) prove useful should the courts adopt Lords Hoffmann’s and Hope’s reasoning in *Transfield* when determining what falls to be recovered (see box “*Transfield*”).

The remainder of the limitation clause should still, at its core, distinguish between direct and indirect (or consequential) loss. These are concepts which, if not always predictably applied, are at least supported by a significant body of case law. Should a dispute arise over the loss that is recoverable under the contract, the traditional arguments as to whether such loss is direct can be relied on in conjunction with the inclusion clause.

Agree sensible financial caps. Parties who are unfamiliar with the concept of an inclusion clause may be unwilling to contract on this basis; preferring instead to rely on “tried and tested” exclusion provisions and the familiar distinction between direct and indirect loss.

The sensible use of financial caps, applied both globally to the contract as a whole, as well as individually, where appropriate, in relation to specific heads of loss, will assist the parties to reach a fair compromise. In the context of a traditional customer/supplier relationship, the customer can take comfort from the fact that it is certain to recover at least a proportion of the defined included “high risk” losses it has identified. The supplier is protected, in that its exposure to each identified loss is clearly defined and capped.

There is often a fundamental misconception among clients that contractual damages will, or in fact should, fully compensate them for the loss they may suffer under a contract for contract failure. It is not realistic, nor in most cases commercially reasonable, for one party to a contract to expect to recover all of its losses from the other in the event of contractual breach.

Faced with this commercial reality, lawyers should seek to achieve a fair allocation of the risk associated with contractual breach as between their client and the other party. When viewed as a commercial discussion around allocation of risk, a liability inclusion clause, with appropriate financial caps for each identified area of loss, will result in both parties assuming commercially appropriate levels of responsibility for contract failure.

Should all liabilities be capped financially? In the current economic climate it is not unheard of for a party simply to walk away from a contract in which its liability is capped, taking the view that a quantifiable claim for damages is a better commercial option than being bound under a contract which it now believes to be a bad bargain.

While there is a valid argument that the court would rule that the cap was never intended to apply to a case of deliberate breach (see, for example, *Internet Broadcasting Corporation (trading as NetTV) v MAR LLC (trading as MARHedge)* [2009] EWHC 844; www.practicallaw.com/9-386-1775), for clarity the parties should expressly state in the limitation clause that the cap will not apply in the case of a party's wilful default (or, to the extent it does, the capped amount should be substantially increased).

Sample clause

The following is an example of customer- friendly inclusion clause in an IT supply agreement:

Notwithstanding Clause [enter reference to exclusion clause], for the purposes of this Agreement losses for which the Supplier assumes responsibility and which shall be recoverable by the Customer shall include, but not be limited to, the following:

- * Monies paid by the Customer to the Supplier pursuant to this Agreement, in respect of any good or service not provided in accordance with the terms of this Agreement.
- * The costs and expenses reasonably incurred by the Customer in procuring and implementing alternative or replacement services including consultancy costs, the additional costs of management time and other personnel costs and costs of hardware, software and other equipment and materials.
- * The costs and expenses reasonably incurred by the Customer in contemplation of and pursuant to this Agreement to the extent that such costs and expenses are wasted if alternative or replacement services are procured.
- * The costs and expenses of reconstituting or reloading lost or corrupted data.
- * The costs and expenses of implementing and performing workarounds following a Service Failure.
- * Losses incurred by the Customer arising out of or in connection with any claim, demand, fine, penalty, action, investigation or proceeding by any third party (including any Sub-Contractor, Supplier Personnel, Regulator or customer of the Customer) against the Customer caused by the act or omission of the Supplier, any Sub-Contractor or any Supplier Personnel.

Drafting notes

The losses set out above represent the core elements of a customer-friendly inclusion clause in the context of IT supply agreement. Particular heads of loss can be added (for instance, loss of revenue or loss of anticipated savings) or removed, depending on the party you are acting for and the commercial facts of the particular deal.

The remainder of the limitation clause should be tailored to take account of the wording in the inclusion clause. In particular:

- * Any general exclusion of indirect loss or consequential loss should be made subject to this provision.
- * The financial caps that are to apply to each head of recoverable loss should be clearly set out in a subsequent provision, together with an express reference to those heads of loss which are to sit outside the caps in any event.
- * Specific reference should be made to the fact that the financial caps will not apply in the case of wilful default by the Supplier.

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