Lunch & Learn: Direct & Indirect Damages: How the Difference Affects Contract Drafting

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Presented By Alistair Maughan
Lunch & Learn

- 2nd Monday of each month
- 45 minutes via webinar
- Unaccredited CPD points
- Rolling 3 month schedule
  - **Monday, 9 June:**
    “Issues with Mobile Apps”
    Speaker: Chris Coulter
  - **Monday, 14 July:**
    “Recent and Current Developments in TUPE and Acquired Rights Directive”
    Speaker: Ann Bevitt
  - **Monday, 8 September:**
    “Corporate Use of Social Media: 10 Top Tips”
    Speaker: Sue McLean
• Questions at the end. Or e-mail me afterwards

• Phones are muted to reduce background noise

• I’ll unmute at the end
1. Core Principles

2. Loss of Profits

3. Liability for Wilful Breach

4. Data Breach

5. What cannot be excluded?

6. How not to exclude Indirect Loss

7. What do we see in Practice?

8. Civil Law Comparison
Why is this Issue Relevant?

- The difference between “direct” and “indirect” damages is a very broad subject, and very fact-specific

- Many misconceptions:
  - Direct losses are smaller than indirect losses
  - Loss of profit and economic loss are indirect
  - Loss of reputation and goodwill are irrecoverable
  - Consequential loss is not recoverable

- Recent cases are widening the scope of direct loss
Centrica v Accenture

GB Gas Holdings v Accenture (UK) [2009]

Accenture contracted with Centrica to provide a new customer billing system. The contract excluded liability for:
- loss of profits or contracts arising directly or indirectly
- loss of business or revenues arising directly or indirectly
- losses or damages to the extent that they are indirect or consequential or punitive

Following a breach by Accenture, Centrica claimed for:
- extra gas distribution charges
- compensation paid to its customers on *ex gratia* basis to counter reputational damage to Centrica
- additional borrowing by Centrica necessary to finance its business as a result of a drop in revenue due to incorrect billing
- cost of chasing customer debts not actually due
- stationery and correspondence costs resulting from updating customers on the management of particular incidents

Accenture argued that such classes of loss fell under the head of indirect loss and were irrecoverable
• 3 Key Principles of Liability
  • Fault
  • Causation
  • Remoteness

• **Hadley v. Baxendale** (1854). Claimant will be able to recover:
  • losses arising naturally, according to the normal (or ordinary) course of things, from the breach of contract itself = FIRST LIMB
  • such loss as may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract, as a probable result of the breach = SECOND LIMB
1854!? You’re kidding, right?

**U.K.**
- Still key test (*Sylvia Shipping*, 2010)
- 1st Limb = Direct Loss
- 2nd Limb = Indirect Loss or Consequential Loss

**U.S.**
- “Time-honored rule” (*Joan Hanson v Everlast*, 2010)
- 1st Limb = often called General Damages
- 2nd Limb = Special or Consequential Damages

*Hadley v Baxendale* is easier to state than it is to apply. If in doubt, exclude specific types of loss (thus avoiding the direct/indirect classification completely)
**Supershield Ltd v Siemens Building Technologies FE Ltd [2010]**

- Storage tank for sprinkler system overflowed causing flood
- Principal cause – failure of float valve
- Back-up safety measures (drainage and warning system) failed
- Supershield (subcontractor) responsible for installing float valve but not for back-up safety measures
- Supershield argued – loss too remote (failure of back-up safety measures an unlikely event)
Supershield v Siemens

Held:

- Cause of damage = flooding as a result of valve failure
- Failure of back-up measures was unlikely but this does not make resulting loss too remote

Implications:

- For suppliers:
  - reliance on standard exclusion of indirect and consequential loss may not be enough
  - make it an express requirement on customer to provide relevant back-up systems or measures
  - exclude liability for specific risks
- For customers:
  - expressly include recoverability of specific risks OR
  - stay silent?
**Loss of Profits**

**UK**
- Lost profits are recoverable
- UK courts changed course in mid-90s
- Main issue is how to establish damages with sufficient certainty

**U.S.**
- Lost profits are recoverable…
- … but need to be established with reasonable certainty
- Different approaches to established and new business lines
McCain Foods v Eco-Tec

McCain Foods v Eco-Tec [2011]

McCain had a waste water treatment system, producing biogas; bought a system for removing hydrogen sulphide from the biogas, so they could use it as fuel to generate heat and electricity in a combined heat and power plant. The contract excluded liability for "indirect, special, incidental and consequential damages". The system supplied was defective and proved impossible to commission. McCain claimed damages for breach of contract:

- £350,000: Cost of buying another system to replace the one supplied.
- £550,000: Extra cost of buying electricity instead of generating it from their own biogas
- £650,000: Loss of revenue from the system; specifically, from selling Certificates of Renewable Energy Production
- £100,000: Cost of contractors, site managers and health and safety personnel.
- Various smaller claims for the costs of staff time spent on resolving the problems, reasonable attempts to mitigate the loss, independent experts and laboratory testing, buying more equipment and civil works from the supplier and from others

Supplier accepted that the cost of replacing the system was direct loss, but argued that all the other losses were indirect and therefore excluded by the contract.

The High Court held that these all were the type of damage that arises naturally, according to the usual course of things, from the breach; that made them direct losses, not indirect losses. The exclusion clause did not reduce the claim at all.
Liability for Willful Breach

**UK**

- Cases divided
- *Internet Broadcasting (t/a NETTV) v MARHedge [2010]*: there is a rebuttable presumption that an exclusion clause should not apply to deliberate personal repudiatory breach of contract; court will require very clear drafting to allow exclusion clause to cover deliberate repudiatory breach
- *AstraZeneca v Albemarle [2011]*: Court said that *MARHedge* was wrong, and rejected the idea that deliberate breaches of contract should be treated differently from other breaches

**U.S.**

- Deliberate conduct should not affect measure of damages
  - Requires more than a “mere breach of contract”
  - Willful (or wanton or reckless) misconduct or malice or
- Courts look for a special relationship or duty between the plaintiff and defendant to warrant additional tort based recovery
Data Breach

• Providers often refuse to indemnify for data breaches (and customers may prefer to defend claims involving personal information of employees or customers)

• Data breach losses and expenses vary in kind:
  • Investigation
  • Remediation
  • Notices, credit reporting and other “industry standard” practices
  • Third party claims, including defense/court costs
  • Fines and penalties

• Best to specify the provider’s obligations with data breach losses and acknowledge in the contract that amounts are recoverable

• **But** expect many providers to require a cap on their exposure
What cannot be excluded?

- **UK:** Any exclusion of loss is subject to Unfair Contract Terms Act
  - Reasonableness test
  - Depends whether dealing as a consumer or as a business

- **U.S.**
  - Subject to certain exceptions (public policy, consumer protection, UCC), courts generally allow parties to a contract to agree on limitations.
  - Some exceptions for gross negligence or wilful misconduct (but a high threshold)
Reasonableness in the UK

Unfair Contract Terms Act (UCTA)

- applies where one party is dealing as a consumer or on other’s standard terms
- not applicable to “international supply contracts”
- will override choice of foreign law clause where one party deals as consumer
- sets out how liability of parties for breach of particular terms can be limited/excluded
- applies to B2B and consumer contracts but B2B contracts are able to exclude liability for breach of wider variety of terms (subject to reasonableness test) than B2C contracts
- whether B2B or B2C, death or personal injury caused by a party’s negligence can never be excluded
- guidelines to establish whether a term will be held to be reasonable or not
- there is also extensive body of case law on this topic
**The Lobster case**

**Lobster Group v Heidelberg Graphic Equipment Ltd and Close Asset Finance [2009]**

- Warranty agreement for printing press contained exclusion clauses:

  “10(c) This guarantee is confined to replacement or repair at [warrantor’s] option of the defective part and the repair of any damage to the equipment arising from the failure of the said part and any payment by way of damages whether for immediate or consequential loss is hereby expressly excluded”

  “13 In any event, notwithstanding anything else contained in this contract, in no circumstances shall [warrantor] be liable in contract, tort (including negligence or breach of statutory duty) or otherwise howsoever and whatever the cause thereof: (i) for any increased costs or expenses (ii) for any loss of profit, business contracts, revenues or anticipated savings; or (iii) for any special, direct or consequential damage of any nature whatsoever said to have occurred consequent upon the supply or the circumstances of the supply of the goods or services here contracted to be supplied by [warrantor] or any sub-contractor to its customer”
The Lobster case

Lobster Group v Heidelberg Graphic Equipment Ltd and Close Asset Finance [2009]

Held:
- Exclusion of “immediate loss” in 10(c) and of “increased cost and expense” in 13(i) was unreasonable
- Unreasonableness goes to whole of the provision therefore entire provision is void
How not to exclude Indirect Loss

*Markerstudy Insurance v Endsleigh [2010]*

“Neither party shall be liable to the other for any indirect or consequential loss (including but not limited to loss of goodwill, loss of business, loss of anticipated profits or savings and all other pure economic loss) arising out of or in connection with this Agreement.”
What do we see in practice?

Neither Party excludes or limits its liability for:

- death or personal injury caused by its negligence, or that of its employees, agents or sub-contractors;
- bribery, fraud or fraudulent misrepresentation by it or its employees; or

In no event shall either Party be liable to the other for any:

- loss of profits;
- loss of business;
- loss of revenue;
- loss of or damage to goodwill;
- loss of savings (whether anticipated or otherwise); and/or
- any indirect, special or consequential loss or damage.

The Supplier shall be liable for the following types of loss, damage, cost or expense which shall be regarded as direct and shall (without in any way, limiting other categories of loss, damage, cost or expense which may be recoverable by the Authority) be recoverable by the Authority:

- any regulatory losses or fines arising directly from a breach by the Supplier of any Laws; and
- any additional operational and/or administrative costs and expenses arising from any Material Breach.

Cap on damages?
Uncapped losses?
Interest?
Core Principles under German Law

Legal Basis: Sec. 249 – Sec. 254 German Civil Code as interpreted by German court decisions (case law)

Basic Test:

- **Fault**: negligent or wilful breach of a contractual obligation or statutory provision

- **Adequate Causation**: affirmed when it is not completely unlikely that the given fault causes the suffered loss according to the ordinary course of events and the general experience of life
  
i.e., excludes only losses that occur under very special and unlikely circumstances (e.g., adequate causation even affirmed for vaccination damage although likelihood of adverse effect of vaccination is less than 0.01%)

- **Protective Purpose of the Provision**: requires a connection between the breach and the loss.
  
i.e., the loss must be the realization of risks the prevention of which is (also) the purpose of the breached contractual obligation or statutory provision (e.g., exceeding a speed limit would only be causal for a car accident if the accident could have been avoided without the speeding)
All losses passing the foregoing test are recoverable

- **No differentiation between direct and indirect loss**
  
  Differentiation *only relevant* in cases involving *hypothetical damage causation* where certain *indirect* damages may not be recoverable.

  **Direct loss:** loss concerning the damaged object/interest itself
  
  *(e.g., defect of the delivered web shop software, costs to eliminate the defect and make the software operational)*

  **Indirect loss:** any other losses that concern assets other than the damaged object/interest
  
  *(e.g., as result of the software defect, company could not sell products on its web shop and lost profits)*

- **Recovery of Lost Profits**
  
  expressly *included by law* (Sec. 252 German Civil Code):

  “Those profits are considered lost that in the normal course of events or in the special circumstances, particularly due to the measures and precautions taken, could likely be expected.”
How to exclude liability for losses?

**No Exclusion or Restriction of Liability for:**

- wilful breach of obligations, fraud, fraudulent misrepresentation or fraudulently concealed defects, breach of a guaranty given for a certain quality of a product

**Agreements individually negotiated between the Parties:**

- **Avoid** general exclusion of “indirect losses” without any specification of such losses as there is no clear definition by statutory law or case law
- **Specify** the types of losses/risks to be excluded or limited (e.g., lost profits, loss of use, costs to restore other systems and data of customer affected by a software defect, loss of “goodwill”, losses resulting from a delay in delivery)
- **Cap** (or even **exclude**) liability for (gross and ordinary) negligence for each damaging event and in total
- **Restrict** liability to losses that may typically and foreseeably arise under the respective type of contract
- **Exclude** liability for any negligent breach of non-material contract obligations
Exclusion/Limitation in Standard Terms?

- Clauses in standard terms of one party that represent an **unreasonable disadvantage** to the other party are **invalid** under German statutory law.

- **Invalid** exclusion/limitation of liability in B2C and B2B (!) standard terms:
  - death or personal injury caused by negligence or wilful conduct
  - gross negligence (see exception for B2B below)
  - breach of material contract obligations by ordinary/slight negligence

- **Valid** limitations/exclusions for B2B:
  - breach of **non-material/ancillary obligations** by ordinary/slight negligence
  - losses caused by **ordinary/slight negligence** that were **unforeseeable** and **untypical** for such type of business when entering into the contract
  - **gross negligence** of the party’s vicarious agents other than its executive staff
  - Liability caps only for ordinary/slight negligence **and** only if
    1. cap covers the typical risks of loss under the respective contract
    2. cap is industry custom (e.g. German freight forwarding agents)

If possible, individually negotiate liability clauses with business partners.
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