The problem with indirect and consequential loss

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"*Neither party will be liable for any indirect or consequential loss under or in connection with this contract*". You've probably seen this type of "exclusion clause" hundreds of times in ICT and other commercial contracts and not thought much of it. It's a 'legal' term right? It's very standard and the lawyers know what it means, don't they?

Even if the lawyers involved can't quite recall the details, they probably remember from law school that there are some cases about indirect loss and, in my experience, they often assume that the terms have some ascertainable legal meaning. In addition, ICT suppliers often claim its 'corporate policy' to include these clauses in every contract and they usually want a whole lot of other losses excluded also, such as 'loss of profit', 'loss of goodwill' or 'economic loss' (whatever that means).

In truth, while the terms 'indirect loss' and 'consequential loss' probably mean the same thing, there is a great deal of uncertainty about what they do mean and no well-understood and easily-applied test. What an exclusion clause actually excludes will depend on very much on the facts of the particular case, what country you are in, and, potentially, the judge you get on your day in court.

In England the courts have held that 'indirect and consequential losses' are the same as the damages that a court can award following the second limb of an 1854 case called *Hadley v Baxendale*. Second limb damages in that case are losses which don't arise in the usual course from the breach but nevertheless could "*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*". If that's the test, then by including that exclusion clause parties are agreeing that they can't recover a class of losses that might be unusual or specific to the particular situation but both parties absolutely knew would be suffered if there was a breach. I don't think many parties have these types of losses in mind when they read exclusion clauses.

That's not the end of the story. The case law in New Zealand, Australia and in England (which may all be relevant to how the New Zealand courts will interpret the phrase) calls into question whether *Hadley v Baxendale* is the actually the right place to start to determine what the words mean. Various courts have come up with all sorts of other tests, looking at whether losses are 'reasonably foreseeable', 'on the cards' or 'flow directly from the breach'. All of these tests have been criticised and all are difficult to apply in practice. If anything, the cases simply serve to demonstrate how the courts can come to varying decisions when interpreting much the same words in their context.

Over time there seems to be a move towards the courts essentially saying, "let's not worry about the case law relating to damages, let's treat this as an exercise in contractual interpretation and determine what these parties meant when they included the clause" (the decision of Clifford J in *Oceania Furniture Limited v Debonaire Products Limited* is a good example of this approach). This is all very well and good if the parties actually had something in mind. It's less helpful if the parties didn't even consider what the clause meant or, as is often the case, put it in the too-hard basket and assumed a court would later arrive at a sensible solution in a dispute or that they'd never get that far.

Despite the uncertainty, suppliers often insist on including exclusion clauses – perhaps taking comfort from the fact that even if they really do stuff up, there will still be room to argue that they shouldn't have to pay for certain types of losses. That's not such a great position to be in if you're a customer.

So what's the solution? There are three basic options:

- **Don't include an exclusion clause at all** – one school of thought is that a party should be on the hook for all the losses a court would award and the better way of addressing any uncertainty is to agree a cap (or caps) on all types of losses that both parties are happy with. Unfortunately, it's frankly very hard to convince people to go with this option.
- **Include an exclusion clause and live with the uncertainty** – this is often the preferred option, particularly if the parties don't foresee themselves ever having to resort to the clause (although most parties who end up in court probably didn't either). Parties taking this option should understand that when they get into a dispute and go to a lawyer and ask "what types of losses can I recover?", the lawyer probably won't be able to give them a certain answer and they may not be able to cover losses that they've actually suffered and expected to be compensated for. So they are really making a choice to forego spending more time and money at the contractual negotiation stage but may potentially face increased time and money to sort out disputes about liability should disputes arise.

- **Draft bespoke clauses** so that the exclusion clause doesn't apply at all to the most egregious actions (eg wilful default, breach of confidentiality) or things the customer really can't control or predict (eg IP infringements). This is a pretty common approach. It's also increasingly common (and in my view worthwhile) to provide in the contract that certain categories of predictable losses are deemed to be direct losses and recoverable (subject to any caps).

Put simply, don't assume that these common contractual terms have a well-understood meaning, or it you think you've agreed what they do actually, write it down in the contract!

This article was written by Amy Ryburn, partner in our TMT team, for the IITP Techblog (2 November 2015). The original article can be found here.

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