

The meaning of 'consequential loss' and its effect on drafting exclusion and limitation clauses

How would you feel if found to be liable for losses you thought were excluded by a contract? This may very well be the case if the contract fails to effectively allocate risk between the parties.

The phrase 'indirect or consequential loss' is frequently buried in many standard-form exclusion clauses. Parties use this phrase thinking (often mistakenly) that they are excluding all potential liability for loss of profits, loss of revenue or loss of business opportunity. The meaning of the phrase, however, is still far from clear under Australian law and should be used carefully.

The meaning of 'consequential loss'

It is well established in the United Kingdom and Australia, as a result of the decision in *Hadley v Baxendale* (1854) 9 Ex 341 ("*Hadley v Baxendale*"), that where a party to a contract is in breach, the damages which the other party is entitled to fall under two limbs:

1. loss arising naturally from the breach ("direct loss"); and
2. loss that is reasonably contemplated by the parties as a probable result of the breach ("indirect loss").

'Consequential loss' is often associated with indirect loss or the second limb of *Hadley v Baxendale*. That is, it is assumed to be loss that is contemplated as a probable result of the breach rather than loss naturally arising from the breach. This has been most recently confirmed in Australia in *Peerless Holdings Pty Ltd v Environmental Systems Pty Ltd* [2006] VSC 194.

An overview of cases reveals that the types of loss encompassed within the meaning of 'consequential loss' may vary according to the character and subject matter of the contract. Although loss of profits or loss of revenue have long been associated with loss that is one step removed from the transaction, a number of recent cases have held that these losses may be classified as a direct loss, and therefore recoverable despite the contract excluding liability for 'consequential loss'.

One such case, *GEC Alsthom Australia Ltd v City of Sunshine* (Federal Court, Ryan J, 20 February 1996, unreported) ("*GEC v City of Sunshine*"), involved a breach of contract claim brought by GEC against the City of Sunshine who were contracted to supply gas to GEC.

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The indemnity clause in the contract provided that the City of Sunshine would indemnify GEC in respect of any "... direct loss (other than any consequential loss)". GEC argued that the indemnity for direct loss was intended to cover all loss which would flow directly from the breach, including anticipated revenue.

Ryan J accepted GEC's argument and found that the indemnity clause was sufficient to provide GEC with an indemnity for damage flowing directly from the breach, including any loss of anticipated profits. His Honour did not regard loss of revenue as 'consequential loss' and held that 'consequential loss' was confined to that which GEC might incur as a result of being unable to use its plant or capital investments for a purpose extraneous to that directly contemplated by the contract documents.

The meaning of 'consequential loss' has not been directly considered by an Australian Court since the decision in *GEC v City of Sunshine*. This lack of judicial consideration, and the fact that categorisation of loss varies according to the subject matter of the contract, means that the definition is fluid and open to future interpretation.

Drafting exclusion clauses

Exclusion clauses are notoriously difficult to draft and therefore parties and/or their legal representatives often resort to using standard-form clauses from archaic precedents. This frequently results in a clause that is void in the context of the agreement, one that doesn't achieve its objective or does not reflect trends in case law. This problem can be avoided by keeping in mind some simple drafting tips:

- Prior to drafting, evaluate which losses will likely, in the circumstances, be classified as direct or indirect and exclude, restrict or limit a party's liability accordingly.
- Draft the clause in plain English and avoid words which are unclear to those without legal knowledge.
- Avoid relying on clauses excluding liability for 'consequential' or 'indirect' loss to cover loss of profits, loss of revenue and loss of opportunity. Instead, specify exactly what loss is being excluded or limited.
- It is usually prudent to make each individual exclusion or limitation clause self-standing. This will ensure that the intended restrictions on liability are effective.
- Ensure that exclusion clauses give effect to the intentions of the parties rather than standing in isolation from the commercial terms of the contract.
- Depending on the circumstances, it is usually good practice to expressly state whether liability is excluded for death or personal injury caused by negligence.

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