ISN'T ALL LOSS CONSEQUENTIAL? A REVIEW OF RECENT CASE LAW AND ITS RELEVANCE TO CONTRACTUAL PRACTICES WITHIN THE BUILT ENVIRONMENT

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The term "consequential loss" frequently arises during contract negotiations in the context where one party is seeking to limit their liability should they subsequently breach that contract. Parties may have different understandings of the term and typically an exclusion clause will not solely relate to consequential loss, but will also include other heads of losses for which the party will not be liable for, such as loss of profit, loss of revenue and loss of business. The question emerges as to whether the term consequential loss has a definitive legal meaning in its own right. This study seeks to ascertain the definition of the term consequential loss within the construction industry through a review of the legal position regarding liability for breach of contract and consequential loss through the consideration of the case law relating to this topic and the associated secondary sources of information. The study concludes by elucidating a clear interpretation of the term consequential loss when used in contract law.

Keywords: contract law, consequential loss, damages, exclusion clause.

INTRODUCTION

Parties who enter into contracts are seeking to balance the risk and reward derived from that contract. The normal remedy for breach of contract in English law is to pay damages. Oliver Wendell Holmes wrote *"the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it - and nothing else,"* (Wendell Holmes, 1897).

However, the ability to recover damages for all losses is likely to discourage commercial transactions (Collins, 1993). Therefore it is common when negotiating contracts that the party providing goods or services will seek to limit their liability arising from a breach. This is where the problem develops though as according to Forfaria *"the law of damages …suffers from an abundant terminology. In many cases, the words have lost their original meaning [and] require some elucidation,"* (Forfaria, 2006).

There are various ways in which liability can be limited. It may be by way of providing a financial cap on liability or by defining the types of losses that the party will be liable for as a result of a breach. Adopting the latter option, in defining the

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type of losses that the party will be liable for, the traditional approach is to define liability by exclusion. However, in doing this the parties *"often rely on concepts and terminology which are not readily understood …[and]…are not necessarily relevant to the commercial risks of that particular deal,"* (Sumroy *et al*., 2010).

One such particular concept is that of consequential loss, which would appear to be a type of loss a party commonly seeks to exclude from their liability. The hypothesis examined in this paper is that the definition of the term consequential loss, and the type of losses to which it relates is unclear, or not understood at all. Therefore, clarification is required in order that its use is beneficial to those negotiating contracts can do so from an informed position.

THE CASE LAW REVIEWED

The renowned case of Hadley v Baxendale[2], sought to address the complete indemnity suggested by the decision in Robinson v Harman[3]. This case was also heard by Alderson, B, who in his decision provided further clarification of the position, narrowing the obligations established in the earlier case.

The case of Hadley v Baxendale[4] concerned an appeal by a firm of carriers, Baxendale, who had been employed by the owners of a mill, Hadley, to transport a broken mill shaft to an engineering company. The engineering company were to use the broken mill shaft as a model for a replacement shaft. As this was the only shaft the mill possessed, the mill could not work until the shaft was replaced, and so the mill owners requested the shaft be delivered to the firm of engineers the next day.

However, the carriers did not deliver the shaft to the firm of engineers for seven days, during which time the mill lay idle. The owners of the mill therefore sought damages from the carriers for the loss of profits for the period that the mill was unworkable as a result of the delay in delivery of the mill shaft.

During the case, it was considered that the fact that the mill owners only had one mill shaft, so the mill could not operate until the broken shaft was replaced, were *"special circumstances [which] were…never communicated by the plaintiff to the defendants."*[5] Therefore, the case was found for the appellant, and it was held that they were not liable for the loss of profit incurred, as they were not aware that such damage may arise from a result of their breach.

In reaching his decision, Alderson, B established the rule governing the principle of remoteness, which was to apply in circumstances other than those for *"breach of contract in the non-payment of money, or in the not making of a good title for land,"*[6] thus distinguishing this judgment from that he made in the case of Robinson v Harman[7]. The rule is as follows:

"Where two parties have made a contract, which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e. according to the usual course of things, from such breach of contract itself, or

[2] *Hadley v Baxendale* (1854) 9 Ex 341
[3] *Robinson v Harman* (1848) 1 Ex 850
[4] *Hadley v Baxendale* (1854) 9 Ex 341
[5] *Hadley v Baxendale* (1854) 9 Ex 341, 356.
[6] *Hadley v Baxendale* (1854) 9 Ex 341, 355.
[7] *Robinson v Harman* (1848) 1 Ex 850

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."[8]

This established the two categories of damages arising from a breach of contract that a party will be liable for, namely: those damages which *"may fairly and reasonably be considered to arise naturally from the breach"*[9] and those damages *"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."* [10]

These two categories are commonly known as the first and second limbs of Hadley v Baxendale,[11] and this opinion of the court became known as the foresee-ability test, which is described as meaning *"you cannot be held liable for losses that you could not reasonably have anticipated,"* (Brewer, 2004).

It is 160 years since the decision in Hadley v Baxendale[12] was reached and the phraseology of the judgement has come under much criticism during this time, (McGregor, 2009), which has revolved around the understanding of the terms *"arising naturally"*, and *"as the probable result"*. Whilst many alternative terms were suggested, these were also heavily criticised and only led to further confusion. There was therefore a requirement for a restatement of the principle, which was provided by the judgement in Victoria Laundry (Windsor) Ltd v Newman Industries Ltd[13].

The case concerned a contract where the defendant Newman, was to supply the plaintiff, Victoria Laundry with a replacement boiler for their laundry business. Newman was due to deliver the boiler on June 5th 1946; however prior to delivery the boiler was damaged so was not delivered until November 8th 1946, some 5 months later. The plaintiff therefore brought an action to recover damages arising from the late delivery of the boiler, and whilst they were successful in the first instance, the extent of damages they were able to recover, particularly in respect of lost profits went to appeal.

In his judgement, Asquith LJ, re-stated the principles established in Hadley v Baxendale [14] as the following:

The first factor in assessing whether the damages are recoverable by the aggrieved party is the question of whether the damage arising from a breach of contract is *"loss actually resulting as was at the time of the contract reasonably foreseeable as liable to result from the breach."*[15]

The second factor is that what is *"reasonably foreseeable"* depends on the knowledge possessed by the parties which can be either imputed or actual knowledge.

Imputed knowledge is that which *"everyone, as a reasonable person, is taken to know [in] the 'ordinary course of things,"* [16] which is the type of loss contemplated by the

[8] *Hadley v Baxendale* (1854) 9 Ex 341, 354.
[9] *Hadley v Baxendale* (1854) 9 Ex 341, 354.
[10] *Hadley v Baxendale* (1854) 9 Ex 341, 354.
[11] *Hadley v Baxendale* (1854) 9 Ex 341
[12] *Hadley v Baxendale* (1854) 9 Ex 341
[13] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528
[14] *Hadley v Baxendale* (1854) 9 Ex 341
[15] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528
[16] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528, 539

first limb of Hadley v Baxendale.[17] Such knowledge is assumed to be possessed whether or not it is actually possessed.

In addition to imputed knowledge, the actual knowledge the contract breaker possesses may provide for *"special circumstances outside the 'ordinary course of things,' of such a kind that a breach in those special circumstances would be liable to cause more loss."* [18] Such loss in this event is the loss contemplated by the second limb of Hadley v Baxendale[19] and in which event will be recoverable by the aggrieved party.

Asquith LJ, went further to explain that in assessing whether the loss was foreseeable, and hence recoverable, it is not necessary that the party *"should actually have asked himself what loss is liable to result from a breach"* [20]. The question is whether a reasonable man, having considered the situation, would *"have concluded that such loss would be liable to result from the breach,"* and that it is not a requirement to *"foresee that the breach must necessarily result in that loss. It is enough, if he could foresee it was likely so to result"*. [21]

A recent challenge on the principles set out in Hadley v Baxendale[22] was made in the decision of the case of Transfield Shipping Inc V Mercator Shipping Inc (The Achilleas)[23]. This case concerned the damages recoverable for the late redelivery of a ship by the charterers, Transfield, to its owners Mercator.

The redelivery was due for 2nd May 2004, and Transfield confirmed that it would be redelivered by that date. On the basis of this, Mercator entered into a new charter at the rate of $39,500 a day starting 8th May 2004. During this time, the market was exceptionally volatile, and the daily rate for this new charter was significantly higher than was normal in the market. Due to a delay in the final voyage Transfield did not redeliver the ship until 11th May 2004, so Mercator were unable to fulfil the new charter. They entered into a replacement charter, but at a reduced rate of $31,500 per day, and sought to recover damages from Transfield for the late redelivery, on the basis of the difference in the charter rates for the duration of the new charter.

The level of damages sought were in excess of $1.3m, for a delay in redelivering the ship of 9 days, and so the extent of the damages called into question the commercial realities of the principles of Hadley v Baxendale [24].

However, the extent of the damages has never been a bar to recovery under the first limb of Hadley v Baxendale [25]. This principle was upheld in the judgements of Jackson v Royal Bank of Scotland [26] where the House of Lords considered it incorrect to limit loss of profits to a one year period, and of Brown v KMR Services [27] where it was considered immaterial that the degree of loss was unforeseeable, as it was not unlikely that the claimant may suffer some financial loss. Therefore, the claim made by Mercator was initially accepted by the first instance arbitration hearing, on the

[17] *Hadley v Baxendale* (1854) 9 Ex 341
[18] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528, 539
[19] *Hadley v Baxendale* (1854) 9 Ex 341
[20] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528, 540
[21] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528, 540
[22] *Hadley v Baxendale* (1854) 9 Ex 341
[23] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL)
[24] *Hadley v Baxendale* (1854) 9 Ex 341
[25] *Hadley v Baxendale* (1854) 9 Ex 341
[26] *Jackson v Royal Bank of Scotland* [2005] UKHL 3
[27] *Brown v KMR Services* [1995] 4 All ER 598

basis that the loss of a subsequent charter, through the late redelivery of a vessel, was a *"not unlikely"* occurrence. This judgement was also upheld by the High Court and Court of Appeal so went to the House of Lords.

The House of Lords overturned the previous judgement, and whilst this was a unanimous decision, the reasoning of the Lords was divided. The judgement of Lord Hoffman, with support from Lord Hope is of particular interest and is considered by Doe to *"suggest a potential development in law which may have important implications when drafting all kinds of commercial agreements, including construction and engineering contracts,"* (Doe, 2008). This potential development was the principle of the assumption of risk, which Lord Hoffman first identified in the case of South Australia Asset Management Corporation v York Montague Ltd [28], and required a test where *"one must first decide whether the loss for which compensation is sought is of a kind or type for which the contract breaker ought fairly to be taken to have accepted responsibility."* [29]

Lord Hope provided support for the views of Lord Hoffman stating:

"The fact that the loss was foreseeable – the kind of result that the parties would have had in mind, as the majority arbitrators put it – is not the test. Greater precision is needed than that. The question is whether the loss was a type of loss which the party can reasonably be assumed to have assumed responsibility."[30]

In order to apply the assumption of responsibility test, it is necessary to undertake an *"interpretation of the contract as a whole against its commercial background, and this, like all questions of interpretation, is a question of law"* [31] which requires an understanding of implied terms on the basis developed in Liverpool City Council v Irwin[32]

The views expressed by Lord Hoffman and Lord Hope are considered by Halladay to be a broad approach to grounds for allowing the appeal, the benefit of which *"is that you are not seeking to find what the parties would have said, but rather trying to find the ideal default position for that type of contract,"* (Halladay, 2009).

However Lord Rodger and Baroness Hale, with support from Lord Walker took a narrower approach in allowing the appeal, with Lord Rodger summarising this opinion:

"neither party would reasonably have contemplated that an overrun of nine days would 'in the ordinary course of things' cause the owners the kind of loss for which they claim damages. That loss was not the 'ordinary consequence' of a breach of that kind. It occurred in this case only because of the extremely volatile market conditions … this loss could not have been reasonably foreseen as being likely to arise out of the delay in question. It was, accordingly, too remote to give rise to a claim for damages for breach of contract."[33]

[28] *South Australia Asset Management Corporation v York Montague Ltd* [1997] AC 191
[29] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL) 68
[30] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL) 73
[31] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL) 71 (Lord Hoffman)
[32] *Liverpool City Council v Irwin* [1977] AC 239
[33] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL) 81

Lord Walker referred to the principles established in the previous cases of Victoria Laundry [34] and The Heron II, [35] considering that it would be contrary to those judgements to hold the parties liable for losses relating to *"circumstances where the charterers had no knowledge or control over the new fixture entered into by the new owners."*[36]

Whilst the narrow approach was reached on the principles established in previous cases, the broad approach taken by Lords Hoffman and Hope had the potential to question previous understanding of the position with regard to liability for damages for breach of contract and it *"took the view that the notion of foresee-ability was not a sufficient test for remoteness of damage,"* (Lee, 2009).

However, there are specific facts in relation to this case, which are likely to have influenced the Lords in reaching their judgements, so must be considered. In the commercial world of shipping, the liability for loss for the late re-delivery of a chartered ship, in the usual course of events, has been confirmed in a variety of cases including Hyundai Merchant Marine Co Ltd v Gesuri Chartering Co Ltd (The Peonia)[37] as the difference between the charter rate and the market rate, for the period of delay in returning the ship.

Therefore, it could be considered that the owners of the ship were seeking to recover an extraordinary loss which was not a loss that *"might be reasonably expected in the ordinary course of things to flow from the non-fulfilment of the contract."* [38] As such, they would not be entitled to recovery without knowledge of the special circumstances. The judgement is therefore consistent with the principles laid down in Hadley v Baxendale.[39]

To avoid any doubt brought about by Lord Hoffman and Lord Hope as to whether the principles of Hadley v Baxendale [40] were still relevant following the case of The Achilleas[41], the judgement in the case of Sylvia Shipping Co Ltd v Progress Bulk Carriers Ltd [42] confirmed that the assumption of responsibility test was not a test to apply in the general course of things.

This case also related to the chartering of ships, however in this case, the ship's owners failed to make the ship available to the charterers, which resulted in the loss of a sub-charter. The charterer's claimed against the ship owners for the loss of the sub-charter, and contrary to the decision in The Achilleas [43] the claim was allowed as it was considered that the loss of the sub-charter was a loss that was foreseeable as sub-chartering was common practice within the shipping industry. It therefore fell within the first limb of Hadley v Baxendale[44] as it arose naturally, according to the usual

[34] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528
[35] *Koufos v C.Czarnikow Ltd.: The Heron II* [1969] 1 AC 350
[36] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL) 88
[37] *Hyundai Merchant Marine Co Ltd v Gesuri Chartering Co Ltd (The Peonia)* [1991] 1 Lloyd's Rep 100
[38] *Cory v Thames Ironworks & Shipbuilding Co Ltd* (1868) LR 3 QB 181, 190 (Blackburn J)
[39] *Hadley v Baxendale* (1854) 9 Ex 341
[40] *Hadley v Baxendale* (1854) 9 Ex 341
[41] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL)
[42] *Sylvia Shipping Co Ltd v Progress Bulk Carriers Ltd* [2010] C.L.C 470
[43] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL)
[44] *Hadley v Baxendale* (1854) 9 Ex 341

course of things, and as stated in The Heron II [45] was *"not unlikely to result from the breach"* [46].

Hamblen, J confirmed in his judgement in Sylvia Shipping [47], that contrary to suggestions in The Achilleas[48], the principles of Hadley v Baxendale [49] still apply. He stated that the application of those principles were the *"orthodox approach"*[50] which remains the *"standard rule, and it is in only relatively unusual circumstance, such as The Achilleas itself, where a consideration of an assumption of responsibility may be required… it is important to be made clear, that there is no new generally applicable legal test of remoteness in damages."*[51] The relatively unusual circumstances he referred to, in which a test of the assumption of responsibility may apply would be those *"where the application of the general test leads or may lead to an unquantifiable, unpredictable, uncontrollable or disproportionate liability or where there is clear evidence that such a liability would be contrary to market understanding and expectations"* [52]

Whilst the Sylvia Shipping [53] case has confirmed the principles of Hadley v Baxendale [54] a further challenge to this, and further reference to the test of assumption of responsibility was made in the case of Supershield Ltd v Siemens Building Technologies FE Ltd,[55] where Siemens were contracted to install a sprinkler system and they sub-contracted the installation of the tank to Supershield. Due to a failure in a float valve that was installed by Supershield, water escaped into a bunded area; however, the drains to that area were blocked causing water to overflow the bund and damage electrical equipment.

Siemens made claim against Supershield, who argued that the flood arising from the overflow of the bunded area, was too remote a consequence for them to be liable under the proper application of the rules in Hadley v Baxendale[56]. However, Supershield were found to be liable for the losses arising from the flood, and whilst some discussion was made of the assumption of responsibility test raised in The Achilleas [57], Toulson, J succinctly summarised the position with regard to liability for breach of contract as follows:

"Hadley v Baxendale remains a standard rule but it has been rationalised on the basis that it reflects the expectation to be imputed to the parties in the ordinary case, i.e. that a contract breaker should ordinarily be liable to the other party for damage resulting from his breach if, but only if, at the time of making the contract a reasonable person in his shoes would have had damage of that kind in mind as not unlikely to result from a breach. However, South Australia and Transfield Shipping are authority that there may be cases where the court, on examining the contract and

[45] *Koufos v C.Czarnikow Ltd.: The Heron II* [1969] 1 AC 350
[46] *Koufos v C.Czarnikow Ltd.: The Heron II* [1969] 1 AC 350, 382 (Lord Reid)
[47] *Sylvia Shipping Co Ltd v Progress Bulk Carriers Ltd* [2010] C.L.C 470
[48] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL)
[49] *Hadley v Baxendale* (1854) 9 Ex 341
[50] *Sylvia Shipping Co Ltd v Progress Bulk Carriers Ltd* [2010] C.L.C 470, 477
[51] *Sylvia Shipping Co Ltd v Progress Bulk Carriers Ltd* [2010] C.L.C 470, 481
[52] *Sylvia Shipping Co Ltd v Progress Bulk Carriers Ltd* [2010] C.L.C 470, 479
[53] *Sylvia Shipping Co Ltd v Progress Bulk Carriers Ltd* [2010] C.L.C 470
[54] *Hadley v Baxendale* (1854) 9 Ex 341
[55] *Supershield Ltd v Siemens Building Technologies FE Ltd* [2010] 1 CLC 241
[56] *Hadley v Baxendale* (1854) 9 Ex 341
[57] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL)

the commercial background, decides that the standard approach would not reflect the expectation or intention reasonably to be imputed to the parties."[58]

Not only does this confirm that Hadley v Baxendale[59] remains the appropriate test, but also provides clarification regarding the decision in The Achilleas [60] which considered the defaulting party's liability in respect of their imputed knowledge, a requirement that was established by Asquith, LJ in Victoria Laundry [61], and which in the case of The Achilleas [62] reduced the party's liability.

In summary, despite the judgement being handed down 160 years ago, the two limbed test of Hadley v Baxendale[63] remains the overriding principle for establishing liability for damages as a result of a breach of contract. This provides that a party to a contract shall be liable for those losses arising from a breach of that contract which firstly arise naturally, in accordance with the usual course of things, and secondly which are in the contemplation of the parties at the time of entering into the contract as the probable result of the breach.[64] Those losses which occur in the usual course of things are determined by the imputed knowledge, that a reasonable person is taken to know, and also the actual knowledge of special circumstances which will be in the contemplation of the parties at the time of entering into the contract. [65] Such losses shall not be unlikely a result of the breach, which is a lesser obligation from that in tort, except where the special circumstances giving rise to the breach have been made known to the parties at the time of entering into contract.[66] In exceptional circumstances, imputed knowledge can impose an assumption of responsibility which can either reduce, or increase, the liability of the defaulting party.[67]

CONCLUSIONS

There is no succinct, all-encompassing and conclusive definition of the term consequential loss under English law, but the courts have sought to determine a definition through the application of principles established in the case of Hadley v Baxendale. [68] This case has received widespread and enduring acceptance over the years and has been described as *"a fixed star in the jurisdictional firmament,"*(Gilmore, 1974). However it is a case which did not concern the term consequential loss, and it could be argued did not even concern a breach of a specific contract.

The current position in English law is that the division between direct and consequential loss has been drawn along the lines of the first and second limbs of Hadley v Baxendale, [69] yet the divisions between these is not clear cut. The second limb requires knowledge of special circumstances, yet once these special circumstances are known there is the potential for the damages to be considered direct rather than consequential, so the two limbs become one. Sedley LJ acknowledged this

[58] *Supershield Ltd v Siemens Building Technologies FE Ltd* [2010] 1 CLC 241, 253
[59] *Hadley v Baxendale* (1854) 9 Ex 341
[60] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL)
[61] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528
[62] *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 A.C 61 (HL)
[63] *Hadley v Baxendale* (1854) 9 Ex 341
[64] *Hadley v Baxendale* (1854) 9 Ex 341
[65] *Victoria Laundry (Windsor) Ltd v Newman Industries* [1949] 2 K.B. 528
[66] *Koufos v C.Czarnikow Ltd.: The Heron II* [1969] 1 AC 350
[67] *Supershield Ltd v Siemens Building Technologies FE Ltd* [2010] 1 CLC 241
[68] *Hadley v Baxendale* (1854) 9 Ex 341
[69] *Hadley v Baxendale* (1854) 9 Ex 341

in Hotel Services[70] stating that the limbs of Hadley v Baxendale [71] were *"not a dichotomous but rather a continuous classification."*[72] Conversely, it could be argued that if there was no knowledge of the special circumstances which enabled the loss to arise, there would be no liability in any case, and so a reference to consequential loss would become redundant.

The courts have clearly struggled with interpreting the definition of consequential loss, and this is evident by the fact that there is difficulty in identifying any case precedent where the judgement has disallowed recovery of a loss on the basis of it being excluded by a consequential loss clause.

Based on the above study, the meaning of consequential loss remains elusive and ultimately unnecessary and the principles of liability arising from causation, foreseeability and knowledge, both imputed and actual, would be no less effective without it. Therefore the use of the term consequential loss in limiting liability is of little benefit, and the *"best way forward"* and the only way to be sure of reducing ones liability *"is to specify in exclusion clauses precise definitions of the possible damages that are excluded or included"* (Chetwin, 2011).

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[70] *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] BLR 235
[71] *Hadley v Baxendale* (1854) 9 Ex 341
[72] *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] BLR 23, 240

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