

CASE NOTE

An International Issue: 'Loss of Profits' and 'Consequential Loss'

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A recent decision by the New York Court of Appeals in *Biotronik AG v Conor Medsystems Ireland Ltd*¹ has caused a stir among legal practitioners in New York. The court held that the lost profits arising from a collateral contract with a third party constituted general (direct) damages and was not exempted by a 'consequential damage' exclusion clause. Previously, it was widely thought that all loss of profits would be covered by consequential loss exclusions.

The issues addressed by the New York courts in *Biotronik* will be of interest to lawyers in numerous industries where 'consequential loss' exclusions are commonplace and lawyers involved in transactions come from differing legal traditions. Among other things, it serves to highlight cross-jurisdictional differences in contractual interpretation and the importance of carefully drafting 'consequential loss' exclusion clauses.

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¹ 2014 WL 1237154 (NY 27 March 2014).

Legal foundations of ‘consequential loss’

The general ‘rule’ under English law for the recovery of damages following breach of contract was set down in *Hadley v Baxendale*.² Recoverable damages are those either (i) arising naturally or directly from the breach of contract (‘direct loss’), or (ii) within the contemplation of the parties at the time they made the contract (‘indirect’ or ‘consequential loss’). Other losses are irrecoverable as remote.

The second limb of loss in *Hadley v Baxendale* covers situations where there is knowledge of ‘special circumstances’ at the time of the contract and a party has therefore been put on notice of a type of ‘exceptional loss’,³ which would not arise in the usual course of things, that by reason of that notice it has effectively undertaken to bear in the event of a breach.

Since it was handed down in 1854, the approach set out by Baron Sir Edward Hall Alderson in *Hadley v Baxendale*, has been adopted in other common law countries. As far back as 1894, the United States Supreme Court accepted *Hadley v Baxendale* as ‘a leading case on both sides of the Atlantic’.⁴ *Hadley v Baxendale* has been ‘cited with approval by the highest court in 43 states’ and it has since been referred to by academic commentators as ‘recognised in American jurisprudence as the definitive source of determining when consequential damages may be recoverable for breach of contract’.⁵

Exclusion of ‘consequential loss’ in English law

In English law, where a contract exempts liability for ‘consequential loss’, it will normally be interpreted (in the absence of contractual definition) as excepting a party only from such loss as is recoverable under the second limb of the ‘rule’ in *Hadley v Baxendale*, that is ‘exceptional loss’ relating to ‘knowledge of special circumstances’.⁶

The English courts have repeatedly made it clear that an exclusion of ‘indirect or consequential loss’ does not exclude ‘loss of profit’ that arises directly and naturally from the breach, that is loss of profits that a reasonable business person would expect to flow from such a breach in the usual course

2 (1854) 9 Exch 341.

3 Per Blackburn J in *Horne v Midland Railway* (1873) LR 8 CP 131 at 141.

4 *Primrose v Western Union Tel Co*, 154 US 1 (1894).

5 Diamond and Foss, ‘Consequential Damages for Commercial Loss: An Alternative to *Hadley v Baxendale*’ (1994) 63 Fordham Law Review 665.

6 Lewison, *The Interpretation of Contracts* (4th edn), para 12.14.

of events.⁷ This will often include losses of profit from collateral arrangements with third parties.

However, it is, of course, open for the parties to agree a wider definition of ‘consequential loss’ if they so elect. For those in the oil and gas industry, this is common practice (see for example: Oil & Gas UK Model Form Joint Operating Agreement, AIPN Model Operating Agreement, Crine/LOGIC standard contracts).

In English law, there is a growing body of body of case law that now relates to interpreting the scope of widely drafted ‘consequential loss’ exclusions that seek to extend the scope of excluded losses well beyond that of the second limb in *Hadley v Baxendale*.⁸

Biotronik

The background to the *Biotronik* dispute concerned a distribution agreement between the parties, under which Biotronik was an exclusive distributor for certain areas of a specialised stent. The dispute arose when Conor Medsystems ceased worldwide distribution causing Biotronik to believe it was entitled to damages for lost profits, despite the contract’s provisions excluding ‘any indirect, special consequential, incidental or punitive damage’.

Although New York case law was based on similar historic foundations to that in England, it seems that New York case law was understood by many practitioners to have previously decided that ‘lost profits’ were ‘consequential damages’ when, as a result of the breach, loss is suffered on collateral business relationships. However, in *Biotronik* the New York Court of Appeals reached a different conclusion.

The agreement in *Biotronik* contemplated the resale of the stents and the contractual price was benchmarked against the resale price. On this basis, the contemplation of collateral relationships was found to be the very essence of the contract. The court held that this meant that lost profits were the ‘direct and probable result of a breach and thus constitute general damage’. As general damage, the losses could be claimed by *Biotronik* because they were not excluded by the exemption clause.

7 *Saint Line v Richardsons Westgarth & Co Ltd* [1940] 2 KB 49 and *British Sugar v Projects Limited* (1997) 87 BLR 42.

8 *Glencore Energy UK Ltd v Cirrus Oil Services Ltd* [2014] EWHC 87 (Comm); *AB v CD* [2014] EWCA Civ 22; and *Kudos Catering (UK) Limited v Manchester Central Convention Complex Ltd* [2013] EWCA Civ 38.

Loss of profits in English law

Unlike in New York law, there has been no tendency by the English courts to label 'lost profits' arising from the existence of relationships with third parties as consequential or indirect damages (in the absence of a specific attempt by the parties to so define them).

In many cases, in English law, loss of profits under collateral or on-sale arrangements will be naturally flowing from the breach and likely to be direct loss.⁹ It will only be where the loss is 'exceptional', arising from special circumstances, that the loss is likely to be defined as 'consequential loss'.

However, the law on this subject remains in transition. Ever since *Hadley v Baxendale* there has been debate about whether a specific loss in a given factual scenario falls within the first limb, second limb or is remote – resulting in numerous cases that are difficult to reconcile. The more important question today, however, is why a test adopted by the English courts in 1854, to direct juries as to recoverable losses, is suitable today to establish what the words 'consequential loss' mean in the context of an exclusion clause (in the absence of further description by the parties).

Common law on the move – is the traditional approach still good law?

Before placing reliance on the 'rule' in *Hadley v Baxendale* to define the meaning of 'consequential loss', or on the common law rules on remoteness of damages to limit recoverability, parties should consider the thoughts of the retired English Law Lord, Lord Hoffmann, delivered in a lecture at Edinburgh University, that:

'For my own part I think that, although an excellent attempt was made in *Hadley v Baxendale* to lay down a rule on the subject (ie, recoverable damages), it will be found that the rule is not capable of meeting all cases; and when the matter comes to be further considered, it will probably turn out that there is no such thing as a rule, as to the legal measure of damages applicable in all cases.'¹⁰

9 *British Sugar v Projects Limited* (1997) 87 BLR 42, where Walker LJ rejected the submission that 'consequential loss', to a reasonable businessman, would include 'loss of profits'.

10 Hoffmann, 'The Achilles: Custom and Practice or Foreseeability?' (2010) 14(1) *Edin LR* 47 in which Lord Hoffmann was commenting upon his opinion in *Transfield Shipping Inc v Mercator Shipping Inc (The Achilles)* [2008] UKHL 48. In this case Lord Hoffmann sought to restate the court's task of deciding whether damage was remote as 'the court is engaged in construing the agreement to reflect the liabilities which the parties may reasonably be expected to have assumed and paid for' (see para 28 of Lord Hoffmann's opinion). In other words, the usual approach to contractual construction applies.

Although the English courts have been slow to take up the mantle set down by Lord Hoffmann,¹¹ his suggestion, when taken together with other developments of contractual construction and interpretation over the last 20 years in England, has the potential profoundly to impact how courts and tribunals approach ‘consequential loss’ exclusion clauses.

In *Investors Compensation Scheme Ltd v West Bromwich Building Society (No 1)*,¹² the seminal English case on contractual construction and interpretation, Lord Hoffmann explained that ‘[a]lmost all the old intellectual baggage of “legal” interpretation has been discarded’. It is at least arguable that this ‘old intellectual baggage’ stretches as far as any suggestion that ‘consequential loss’ will normally be interpreted (in the absence of contractual definition) as excepting a party only from such loss as is recoverable under the second limb of the ‘rule’ in *Hadley v Baxendale*.

As Lord Hoffmann himself explained in *Investors Compensation Scheme* ‘[i]nterpretation (in English law) is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract’. If this approach is taken, it is difficult to explain or justify why the words ‘consequential loss’ in a contract must be taken as a rule to mean the second limb of *Hadley v Baxendale*, unless defined otherwise.

Is Australian law defining a new era?

The Australian courts seem to agree and have expressly rejected the suggestion that the words ‘consequential loss’ in a contract should necessarily be understood to mean the second limb of *Hadley v Baxendale*. The Western Australia Supreme Court has established that the meaning of an exclusion or limitation clause, including those referencing ‘consequential loss’, is to be ‘determined by construing the clause according to its natural and ordinary

11 *Siemens Building Technologies FE Ltd v Supershield Ltd* [2010] EWCA Civ 7. In this case, Toulson LJ decided that ‘*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, ie, 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, [*The Achilles* and another case] are authority that there may be cases where the court, on examining the contract and the commercial background, decides that the standard approach would not reflect the expectation or intention reasonably to be imputed to the parties’.

12 [1998] 1 WLR 896.

meaning, read in light of the contract as a whole', that is applying the usual rules of contractual construction and interpretation prevailing in Australia.¹³

As the common law tradition continues to discard the 'old intellectual baggage' of a 'rule-' or maxim-based approach to contractual interpretation, it seems ever more likely that courts across multiple jurisdictions will adopt an approach closer to Australia – in which the usual principles of contractual construction and interpretation of the governing law of a contract, are deployed to ascertain what the words 'consequential loss' mean in the context of the contract in question.

Summary of the law

For jurisdictions that continue to adopt a *Hadley v Baxendale* approach to the meaning of the words 'consequential loss' in exclusion clauses, it seems likely that, at least, elements of lost profits are likely to be 'direct loss' and not exempted by the use of the words 'consequential loss' in an exclusion clause – unless specific additional words are used.

However, if common law jurisdictions were to adopt the approach in Australia, which is also the logical consequence of the approach to contractual interpretation in England since *Investors Compensation Scheme*, it seems that the meaning of 'consequential loss' would be a question for each contract, construed on its own merits, in the context of the governing law selected by the parties. This may (or may not) have the result of exclusion loss of profits – or specific elements of lost profits.

Practical consequences for drafters in an international context

In conclusion, it remains important for parties to understand that different jurisdictions approach the use of the words 'consequential loss' in exclusion clauses from slightly different perspectives. Also, this area of law continues to develop across common law jurisdictions. As a result, parties would be well advised carefully to consider and define what losses should be excluded in a 'consequential loss' clause and not overly rely upon any legal 'rule', or case law, outside the contract to import a definition through legal implication.

13 *Regional Power Corp v Pacific Hydro Group Pty (No 2)* [2013] WASC 356. Also see *Electric Generation Corp t/as Verve Energy v Woodside Energy Ltd* [2013] WASC 36 and *Darlington Futures Ltd v Delco Australia Pty Ltd* [1986] HCA 82.