

Just what is “indirect or consequential loss”?

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1 Introduction

If you act for acquirers of information technology products or services you have no doubt seen it, and if you act for IT suppliers you have probably insisted upon it. In an IT context, a total exclusion of the supplier's liability for indirect or consequential loss is a usual feature of most suppliers' standard terms of business. Usually the supplier considers such an exclusion clause “non-negotiable”. This may often be because the supplier's insurance policy does not cover it for liability for its customers' consequential losses. In any event, with businesses increasingly reliant on information technology, the losses that a business could suffer as the result of a failed system implementation, or even a significant period of down-time for a particular piece of software, could be astronomical and it is understandable that suppliers will wish to limit their potential exposure to this in some way.

This has not escaped the notice of the judiciary. As Judge Thyne Forbes states in *The Salvage Association* case;¹ “Exclusion and limitation clauses, particularly those which exclude liability for indirect and consequential losses, are an accepted feature of contracts such as these in the Computer Industry”.²

Judge Thyne Forbes is correct, but what exactly is being “accepted” in the industry? How far does such an exclusion clause go? Or, to put it another, slightly blunter, way – what exactly are consequential losses?

Before proceeding to answer that question (actually, “answer” may be putting the case a little optimistically), it should be noted that this article looks at the issue in the context of Australian law. Accordingly, no comment is made about the scope of exclusion clauses under United States law or the laws of any other country. The article does however refer to English cases on the basis that, at least on the issue of

contract interpretation, guidance may be gained on the approach that would be applicable in Australia.

2 Consequential versus indirect

To begin with, the phrase “consequential” is confusing in itself. Broadly speaking, damages are only recoverable if they are the consequence of a breach of contract, or another actionable wrong. As Sedley LJ noted in the *Hotel Services* case³ “all recoverable loss is literally consequential”. Nevertheless, the phrase “consequential loss” has certainly entered the IT parlance, more often than not presumably used to refer to loss other than direct loss. In other words “consequential” is used as a synonym for “indirect”. Although both words are often used, it is doubtful that the words are intended to have separate meanings. Rather, it is the cautiousness of lawyers (and perhaps the fear that either term has become of term of art) that has led to use two words where perhaps one would do.

3 Consequential versus direct

Distinguishing consequential losses from direct losses is of course the fundamental question. If a piece of software, due to some error of functionality, crashes for a significant period of time, it is pretty clear that a direct “loss” resulting from that is the loss of the use of the software in that period of time. But what about the time spent by the business trying to resurrect the software, or develop a work around? What about if the failure at that time means that certain sales are lost and will not be able to be recovered?

To examine whether those types of losses would be considered direct or indirect, it is necessary to examine where the distinction comes from, and some recent case examples of its application.

4 A tale of two limbs - Hadley v Baxendale

On one view⁴, the phrase “consequential loss” refers to loss that is within the second limb of the heads of damage outlined in the landmark case of *Hadley v Baxendale*⁵. The relevant, and oft-quoted, statement in that case is:

“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 either arising naturally, i.e. according to the usual course of things, from such breach of contract itself, or 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.”⁶

On this basis, consequential losses are those losses that would have been in the contemplation of the parties at the time they formed the agreement, but that are not those losses “arising naturally” from the breach. That is a tough distinction to make in practice, as most losses contemplated by the parties are losses that will arise “naturally” from the breach. The fineness of the line between the two limbs of *Hadley v Baxendale* may be of benefit to the party arguing that an exclusion of liability for indirect or consequential loss does not cover a particular type of loss. That party would argue that the relevant loss has arisen naturally from the breach and therefore falls within the first limb of *Hadley v Baxendale*, and cannot thus be caught by the exclusion clause.

5 Application of Hadley v Baxendale in a recent case - GEC Marconi v BHP-IT

One of the more recent decisions concerning litigation arising out of a

failed IT project is the Federal Court's decision in the *GEC Marconi v BHP-IT* case⁷. Although there was no exclusion clause at issue that is relevant for the purposes of this article, part of the judgement touches upon the "two limbs" of *Hadley v Baxendale* and can thus shed some light on the question of where the courts draw the line between the two limbs. The facts of the case are quite complicated, with cross claims flying ever which way, and it is not proposed to go into detail about the case or the judgement here. Very briefly, BHP-IT entered into a head contract with the Commonwealth (specifically the Department of Foreign Affairs and Trade) for the development and supply of a system known as ADCNET. BHP-IT entered into a back to back subcontract with GEC Marconi. In the fall out from the failed project, BHP-IT's claims relied in part upon a repudiation by GEC Marconi of the sub-contract.

Discussing the various heads of damage that BHP-IT had claimed for this repudiation, Justice Finn noted that the lost benefit of the head contract (including lost future profits), the project costs incurred by BHP-IT in taking over the role GEC Marconi was supposed to play, and BHP-IT's liability to the Commonwealth incurred due to GEC Marconi's failure to complete its obligations were all "losses falling within the first limb of *Hadley v Baxendale*."⁸

Based on the view that an exclusion of indirect or consequential loss is aimed at excluding the category of loss that fall within the second limb of *Hadley v Baxendale*, Justice Finn's finding that, in this case, lost profits, further expenditure and liability to a third party under the head contract are categories of loss that fall within the first limb, sheds further light on the extent (or lack thereof) of such an exclusion clause.

6 An alternative approach

Harvey McGregor Q.C., in *McGregor on Damages*, takes a slightly different view on the distinction between direct and consequential:

"The normal loss is that loss which every plaintiff in a like situation will suffer; the consequential loss is that loss

which is special to the circumstances of that particular plaintiff".⁹

Again, such an analysis depends on quite a fine line. Under the McGregor formulation, the question will turn on how comprehensive the phrase "in a like situation" is construed. If we have a newspaper manufacturer whose printing press is controlled by a computer system, and that system goes down just before printing begins on a peak sales edition (perhaps the edition immediately prior to the Melbourne Cup), is a plaintiff in a like situation a manufacturer of any product? Or is it a newspaper manufacturer (where presumably, if a paper cannot be printed for a day, those lost sales cannot be recovered)? Does "a like situation" take into account the particular edition that was to be printed? And if it does, what loss is left over to go into the category of "consequential loss"?

7 Some specific examples

7.1 The Salvage Association v CAP Financial Services Ltd

The *Salvage Association* case¹⁰ is worth mentioning as it is one of the few cases to deal directly (albeit briefly) with an exclusion of liability for consequential losses type clause in an information technology agreement. In that case, the Salvage Association (a not for profit marine surveying company), engaged CAP (a rather ironically named software developer, seeing as the liability cap was one of the major issues between the parties) to computerise the Salvage Association's accounting system. The development and implementation of the system did not go to plan and there were many errors and inadequacies of functionality of the system. The Salvage Association eventually terminated the agreement, and engaged another organisation to start a replacement system from scratch.

The relevant exclusion of liability clause in the agreement excluded any of CAP's liability for "any indirect or consequential losses, damage injury costs, expense or loss of any kind whatsoever, including economic loss such as loss of production, loss of profits, or of contracts."

The Court drew a distinction between damages for wasted expenditure and damages for loss of profits and held that while the plaintiff could recover the former, it could not recover the latter. Interestingly, the Court based this on the proposition that a plaintiff must elect between damages for wasted expenditure and damage for loss of profit.¹¹ As the Salvage Association had elected damages for wasted expenditure, it could not also seek damages for loss of profits. The Court did not discuss whether damages for loss of profits would have been barred by the exclusion clause (despite the explicit mention in the clause of loss of profits). It seems implicit that, had the Salvage Association elected to seek damages for loss of profit, it would have been entitled to do so, despite the exclusion clause. In the author's view, this may be due to the wording of the exclusion clause, in that loss of profit is provided as *an example* of a consequential loss. It is thus arguable that losses of profits that are actually direct losses do not fall within the ambit of the clause.

In any event, the Court considered the Salvage Association's direct losses to include the sums paid under the agreement (and under an earlier agreement in which CAP scoped the Salvage Association's requirements and designed the system to be implemented), wasted expenditure regarding the implementation (including payments to a third party who was to run a bureau facility for the system) and, interestingly, wasted management time spent on the failed project.

7.2 Hotel Services Ltd v Hilton International Hotels (UK) Ltd

The *Hotel Services* case¹² concerned a type of hotel minibar that was designed to electronically measure what minibar items a guest had removed. The minibars were installed in various Hilton hotels, yet suffered problems related to the chiller units in the minibars. They were eventually reinstalled without the chillers in just two Hilton hotels, but failed to show a profit and were eventually removed. The primary judge in the matter held that Hotel Services was liable for rental overpaid for the minibars, the

cost of removal and storage of the chiller units and the loss of profit. Hotel Services appealed, arguing that liability for cost of removal and storage of the chiller units and the loss of profit was excluded by an exclusion clause in the relevant agreement. The exclusion clause stated that Hotel Services would not “in any circumstance be liable for any indirect or consequential loss, damage or liability from any defect or failure in the System or any part thereof or the performance of this Agreement or any breach hereof”.

The Court of Appeal (Civil Division) discussed the virtue of deciding these cases by drawing a line between the two limbs of *Hadley v Baxendale*, but it decided that the preferable method was to consider whether there was some “special mutually known fact”¹³ that established the loss, and if not (and the loss passed the test of remoteness) the loss was not “indirect or consequential”. Whether this is an alternative approach to the *Hadley v Baxendale* formulation, or a mere restatement of it, is debateable. In any event, the Court held that neither the cost of removal and storage of the chiller units or the loss of profit was caught by the exclusion clause.

Conclusion

Whether one takes the *Hadley v Baxendale* approach, the McGregor formulation, or the “special mutually known fact” angle, the question of whether a loss is direct or consequential is always going to turn on the particular facts of the case.

That said, while extracting a hypothesis from the above cases would involve almost no end of “ifs” “buts” and “maybes”, it is clear that an exclusion of liability for indirect or consequential losses will not always mean an exclusion for liability of loss of profits. It may also not exclude recovery for the business time spent on the problem, and, if the failure is serious enough, wasted business time invested in the entire project.

This leads to the question – just how useful then is a clause excluding a parties liability for indirect or consequential loss?

Well, at the end of the day, the courts will generally construe exclusion clauses narrowly in the event of any ambiguity, so if a party wants to exclude a particular type of loss, this should be clearly stated. If an IT supplier wants to limit its liability for loss of profits, or wasted management time, or any other sort of specific loss, then those types of loss should be specifically excluded (preferably in a separate sub-clause to the attempted “catch all” exclusion for indirect or consequential loss). For, as you can see from the above examples, leaving it in

the lap of the courts is not going to provide either party with much certainty.

¹ *The Salvage Association v CAP Financial Services Ltd* [1995] FSR 654.

² [1995] FSR 654 at 675.

³ *Hotel Services Ltd v Hilton InternationalHotels (UK) Ltd* [2000] 1 All ER (Comm) 750.

⁴ See for example *BHP Petroleum Ltd v British Steel plc* [1999] 2 All ER (Comm) 544 at 565 (as cited in *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] 1 All ER (Comm) 750 at 757).

⁵ *Hadley v Baxendale* (1854) 9 Ex 341.

⁶ *Hadley v Baxendale* (1854) 9 Ex 341 at 354.

⁷ *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 50.

⁸ *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 50 at para 1171.

⁹ Harvey McGregor Q.C. *McGregor on Damages*, 16th edition, (1997) Sweet & Maxwell Ltd, London p. 20.

¹⁰ *The Salvage Association v CAP Financial Services Limited* [1995] FSR 564.

¹¹ The Court based this on comments by Lord Denning M.R. in *Anglia Television Ltd v Reed* [1972] 1 Q.B. 60 at 63.

¹² *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] 1 All ER (Comm) 750.

¹³ *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] 1 All ER (Comm) 750 at 757.