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Précis Paper

Exclusion and Consequential Loss Clauses in Commercial Contracts

Can liability be totally excluded – what about fraud – unconscionability – four corners rule – particular remedies – direct loss, consequential loss – a very useful session from an acknowledged authority and author.

Discussion Includes

- The importance of freedom of contract in Australian Law
- Can a party totally exclude liability under a contract?
- Is it possible to exclude liability for fraud?
- When can an exclusion clause be unconscionable?
- The construction of exclusion clauses
- The four corners rule
- Clauses that provide for particular remedies
- What is the difference between direct and consequential loss?

Précis Paper

Exclusion and Consequential Loss Clauses in Commercial Contracts

1. In this edition of BenchTV, Joshua Thomson SC (Barrister) and Ian Benson (Solicitor) discuss limitation and exclusion of liability clauses. Mr Thomson SC has extensive experience in commercial cases, particularly contractual, insolvency and building disputes. He is also co-author of *Commercial Contract Clauses: Principles and Interpretation* (2008; 2012; 2015).

General Principles of Contract Law

2. A contract is a legally binding agreement between two parties. The touchstone of contracts and the primary justification for the acceptance of exclusion clauses, consequential loss clauses and exclusive remedy clauses is the concept of 'freedom of contract'. It essentially stands for the principle that the parties can agree to whatever bargain they choose.

3. This principle has been tested over the years as parties have sought to include more and more complicated clauses as a means of excluding or limiting liability for the breach of certain obligations or for certain types of loss. Whether such clauses are valid and enforceable alters the allocation of risk between the parties and this will be reflected in the price of the contract or the consideration each side pays the other.

4. Applying 'freedom of contract' principles strictly would necessarily mean that all such clauses would be valid and enforceable as the parties have provided their voluntary consent to be bound by the terms. The concern of the courts and the legislature is that many of these clauses are ambiguous in their meaning or against public policy such that they should not be enforced.

5. This paper will consider a number of these types of clauses that parties have sought to rely upon and explore the degree to which the courts have steadfastly maintained 'freedom of contract' or compromised on the principle where it is in the interests of justice.

Interpretation of Contracts

6. In *Commercial Contract Clauses: Principles and Interpretation*, 2nd ed., Thomson SC cites Justice Holmes at p.2 who once observed that "nothing is more certain than that parties may be bound by a contract to things which neither of them intended…": OW Holmes, "The Path of the Law" (1897) Harv LR 61 at [463]. This proposition reflects the starting point for the interpretation of contracts – contracts are not construed in line with the subjective intentions of the parties, but rather, Australian law takes an objective approach to the interpretation of contracts. See: *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165 at [40]; *Byrnes v Kendle* (2011) 243 CLR 253 at [59], [98-100].

7. This means that the words in the contract are to be understood by determining what a reasonable person would understand them to mean. The first step in the process is to look at the words themselves, and where they are unambiguous, a court must give effect to that meaning. Importantly, courts do not consider the words of any one clause in isolation but must consider the entire contract when determining the meaning of any individual clause.

8. However, "few, if any, English words are unambiguous or not susceptible of more than one meaning or have a plain meaning. Until a word, phrase or sentence is understood in light of the surrounding circumstances, it is rarely possible to know what it means": *Manufacturers' Mutual Insurance Ltd v Withers* (1988) 5 ANZ Insurance Cases 60-583 at [75,343] per McHugh JA. This proposition means that reference may be had to background circumstances and the context to the creation of the contract in an effort to interpret ambiguous clauses: *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337 at [352].

9. Mason J's statement in *Codelfa* at [352] remains authority in Australia:

> The true rule is that evidence of surrounding circumstances is admissible to assist in the interpretation of the contract if the language is ambiguous or susceptible of more than one meaning. But it is not admissible to contradict the language of the contract when it has a plain meaning.

10. The precise circumstances in which a court may consider surrounding circumstances in an effort to interpret the words of a contract has been the subject of considerable litigation (see: *Franklins Pty Ltd v Metcash Trading Ltd* (2009) 76 NSWLR 603) but is beyond the scope of this paper.

11. In Australia, contract law is largely based on the old common law emerging from Britain although the legislature has attempted to regulate contracts to some extent with protections against "unfair" terms under s 23 of the Australian Consumer Law (*Competition and Consumer Act 2010* (Cth) sch. 2) and "unconscionable" conduct under ss 20-21 of the Australian Consumer Law:

SECTION 23:

Unfair terms of consumer contracts

a. A term of a consumer contract is void if:
   i. the term is unfair; and
   ii. the contract is a standard form contract.

b. The contract continues to bind the parties if it is capable of operating without the unfair term.

SECTION 20:

Unconscionable conduct within the meaning of the unwritten law

(1) A person must not, in trade or commerce, engage in conduct that is unconscionable, within the meaning of the unwritten law from time to time.

SECTION 21:

Unconscionable conduct in connection with goods or services

(1) A person must not, in trade or commerce, in connection with:

(a) the supply or possible supply of goods or services to a person (other than a listed public company); or

(b) the acquisition or possible acquisition of goods or services from a person (other than a listed public company);

(2) engage in conduct that is, in all the circumstances, unconscionable.

Exclusion Clauses

12. Clauses inserted into a contract for the purpose of protecting a contracting party by limiting their obligations are commonly known as exclusion, exemption or protective clauses. They may achieve their desired effect by modifying the primary contractual obligations which one party owes to the other, or by barring, or exclusively prescribing, the remedies which an injured party may claim for breach of a primary obligation. Exclusion clauses represent the former category whilst an example of the latter type of provision is a consequential loss clause, which is explored further below.

i. General Interpretative Rules for Exclusion Clauses

13. In *Darlington Futures Ltd v Delco Australia Pty Ltd* (1986) 161 CLR 500, Mason, Wilson, Brennan, Deane and Dawson JJ at [510] explain that exclusion clauses are to be interpreted in the same way as any other contractual provision:

> These decisions clearly establish that the interpretation of an exclusion clause is to be determined by construing the clause according to its natural and ordinary meaning, read in the light of the contract as a whole, thereby giving due weight to the context in which the clause appears including the nature and object of the contract, and, where appropriate, construing the clause contra proferentum in case of ambiguity.

To construe the clause contra proferentum means that, in the case of ambiguity unresolved by reference to surrounding circumstances, a clause should be construed against the party who prepared the contract or the party who seeks to rely on the ambiguous provision.

Furthermore, to construe a clause according to its natural and ordinary meaning involves a consideration of commercial realities and the ordinary language used in business rather than approaching the language as if it were drafted with legal terms in mind.

14. The High Court has reiterated this approach in *Selected Seeds Pty Ltd v QBEMM Pty Ltd* (2010) 271 ALR 484 at [29]-[30]. It is important to note that this approach would appear to differ from the approach in the UK where *Canada Steamship Lines Ltd v The King* [1952] AC 192 stands for the proposition that an exclusion clause is not construed as exempting a person from negligence unless this is express or necessarily implied.

ii. The 'Four Corners' Rule

15. The 'four corners' rule of construing exemption clauses is also occasionally invoked. Essentially, it describes the process of understanding the operation of an exemption clause in the context of all of the contractual obligations affecting the parties. This is a precursor to the approach adopted in *Darlington* and should be understood to be subsumed in the subsequent formulation.

16. The principle was applied in two illustrative cases. The first of which was *Council of the City of Sydney v West* (1965) 114 CLR 481 which involved the owner of a car suing a car park owner for releasing his car to an unauthorised person who presented an incorrect ticket in order to gain exit from the car park with the claimant's car. The question for the High Court was whether an exclusion clause for negligence applied in order to exempt the car park from allowing the unauthorised person to take the car with a wrong ticket. The majority of Barwick CJ, Taylor and Windeyer JJ considered that the contract required the car park owner to only release the car when presented with the correct ticket for the car. Hence, the breach was simply because of the fact of release rather than any negligence on the part of the attendant. The clause was not intended to protect the car park owner from acts of its employees which were not authorised by the contract.

17. The second illustrative case was *Thomas National Transport (Melbourne) Pty Ltd v May & Baker (Australia) Pty Ltd* (1966) 115 CLR 353. In that case, a carrier took home goods which he was transporting since the depot to which he would normally transport the goods was shut. The goods were destroyed in a fire at his house. The owner of the goods sued the transport company, which sought to rely upon a clause which exempted any loss or damage whilst in transit or storage. Although there was no specifically agreed upon route, a majority of the High Court considered that the transport company was contractually obliged to take the

goods to the depot and that the failure to do so constituted a breach of contract. Further, the exemption clause, on its proper construction, did not apply to this type of breach of contract as it was not contemplated by the parties.

18. In these cases, the High Court inferred or implied a contractual duty that was not specifically mentioned in the contract and held that the breach of this duty was, unsurprisingly, outside the scope of the exemption clause, read naturally. This perhaps represents a subtle judicial technique of bypassing the operation of an exclusion clause.

iii. Limits Upon the Scope of an Exclusion Clause

19. Despite the principle of 'freedom of contract', there are certain limitations upon the extent to which an exclusion clause may exclude liability. For example, an exclusion clause cannot exclude liability for breach of all of a party's obligations. If that were the case, there would be no binding promise for the party to do anything such that the purported contract can only be construed to be a declaration of intent and is termed "illusory": *MacRobertson Miller Airline Services v Commissioner of State Taxation (WA)* (1975) 133 CLR 125.

iv. Limits Upon the Exclusion of Fraud

20. Another limit upon the scope of exclusion clauses prevents clauses that purport to exempt a contracting party from the consequences of fraudulent conduct in inducing the other party to enter a contract: *S Pearson & Son Ltd v Dublin Corp* [1907] AC 351 at [353]-[362]. These types of clauses are said to be against public policy and the principle is expressed and extended in s 18 of the Australian Consumer Law:

> **SECTION 18:**
> ***Misleading or deceptive conduct***
>
> *(1) A person must not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.*

v. Practical Implications

21. In light of these limitations, it appears that the wider the exclusion that a party seeks, the more specific and unambiguous they will have to be in the language they use in furthering this purpose.

Consequential Loss Clauses

22. Consequential loss clauses exclude liability for a party in breach of a contract to pay damages for "consequential loss". These contracts preserve remedial rights for "direct loss", ensuring that the contract is not illusory.

23. What is meant by "consequential" or "indirect" loss is the subject of some controversy. It is possible that a breach of contract whereby a faulty machine is provided to a company would involve (1) the direct loss of replacing the machine and (2) the consequential loss of the lost employee time for which they were paid but performed no work as a result of not having a functioning machine. However, the English and Australian authorities do not necessarily agree on this.

i. Hadley v Baxendale

24. The case of *Hadley v Baxendale* (1854) 9 Ex 341 is often cited to answer this question in the English courts. The rule in *Hadley v Baxendale* prescribes the conditions on which damages can be awarded in respect of loss sustained by reason of a breach of contract: *The Commonwealth v Amman Aviation Pty Ltd* (1991) 174 CLR 64 at [98]. The rule, as stated by Baron Alderson at [354]-[355], is that:

> 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 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. Now, if the special circumstances under which the contract was actually made where communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.

25. Accordingly the rule has two limbs:

    a. Under the first limb, the defendant is liable for loss which *any* reasonable person in his position could have foreseen (**direct loss**); and

    b. Under the second limb, the defendant is liable for loss which could have been foreseen by a reasonable person with the same knowledge of special

circumstances as the defendant had, such as knowledge of the purpose for which the aggrieved party intended to use the subject-matter of the contract (**consequential or indirect loss**).

26. Recent English authority suggests that a contract which excludes liability for consequential or indirect loss is to be construed as excluding liability under the second limb in *Hadley v Baxendale*: *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] 1 All ER (Comm) 750. Therefore, liability in damages for breach where the exclusion clause applies would be limited to losses that only *any* reasonable person could have foreseen, and not to loss that the party could have foreseen with their knowledge of special circumstances.

ii. The Australian Approach

27. The Australian courts have taken a different approach to the English authorities and have instead applied the standard approach found in *Darlington v Delco* i.e. to construe the limitation clause according to its "natural and ordinary meaning, read in the light of the contract as a whole…": *Environment Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26.

28. In *Environment Systems*, the Court determined at [93] that "ordinary reasonable business persons would naturally conceive of 'consequential loss' in contract as everything beyond the normal measure of damages, such as profits lost or expenses incurred through breach". This approach was applied without discussion in *Allianz v Waterbrook* [2009] NSWCA 224.

29. Also applying *Darlington* principles, Martin J in *Regional Power Corporation v Pacific Hydro Group Two Pty Ltd (No 2)* [2013] WASC 356 did not consider that the *Environment Systems* concept of "normal losses" was particularly helpful. His Honour, instead, simply applied the *Darlington* test without referring to the language used in *Regional Power*. What emerged from the decision was the need to understand the nature of the primary obligation breached to determine direct and indirect losses.

30. Whether the *Environment Systems* or *Regional Power* approach is taken, the most effective means of obtaining protections via a consequential loss clause is to specifically name the heads of damage which may not be claimed, such as loss of profits.

iii. Commentary

31. Both the *Hadley v Baxendale* and *Darlington* approaches have their advantages and disadvantages. The advantage of *Hadley* is that the test provides more certainty to commercial decisions. It is significantly easier to accurately determine what will fall into the second limb than to determine what "consequential loss" means under the *Darlington* test

which will differ from contract to contract. On the other hand, the Australian approach may be beneficial for parties in that it enforces a complete analysis of all the facts and the contract as a whole when determining what the parties really understood by the term.

Exclusive Remedy Clauses

32. Exclusive remedy clauses prescribe the remedies available for a particular breach of contract. For example, such a clause may specify that contractually prescribed dispute resolution is to occur following the breach of a particular provision.

33. In *Stocznia Gdanska SA v Latvian Shipping Co* [1998] 1 WLR 574 at [585], Lord Goff of Chievely argued that "clear words are needed to rebut the presumption that a contracting party does not intend to abandon any remedies for breach of the contract arising by operation of the law". This principle has been affirmed in Australia with the decision of the High Court in *Concut Pty Ltd v Worrell* [2000] HCA 64 at [23].

34. This proposition from *Concut* might be seen to create a tension with the principle that an exclusion or limitation clause be read according to its natural and ordinary meaning in light of the nature and object of the contract as a whole. This suggestion has yet to be resolved although it would appear to be a special exception for clauses prescribing remedies to the general principle which applies to exclusion clauses.

BIOGRAPHY

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Joshua Thompson SC was called to the WA Bar in 2001. Prior to that he worked for the Crown Solicitor's Office in WA as Assisting Crown Counsel. He was appointed Senior Counsel in 2012 and his practice involves commercial cases, particularly contractual, insolvency and building disputes. He is co-author of *Commercial Contract Clauses: Principles and Interpretation* (2008; 2012; 2015) and has written for various publications including the Australian Law Journal, Federal Review and Australian Bar Review.

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