

Consequential Damages in International Contracts

The use of the English language in international contracts and the influence of English based legal systems and American lawyers affects contract drafting and understanding most significantly. This is particularly apparent and troublesome in an international context in the case of contract terms that purport to exclude liability for consequential damages.

The creeping Americanisation of international trade is often reflected in the contracts parties agree to enter. Even when both parties to a contract come from countries with civil law rather than common law jurisdictions, one will almost certainly find written terms that have an Anglo-Saxon source. Moreover, many contracts that are actually governed by the substantive law of a civil law jurisdiction will invariably have terms that originate from common law sources.

This common law influence has to do not only with the dominance of the USA in international trade institutions, but also because common law lawyers drafted many of the standard forms of contract in current use and furthermore, English is the international trade language. Even when parties do not use standard forms, they are often picked over by contract draftsmen searching for terms to include in their one-off contracts.

This article examines perhaps the single most important provision of any contract: the exclusion clause. It will be shown that the most common used versions of such terms have their origin in the common law and use language that would be familiar to the common law lawyer but in the context of civil law jurisdictions may be conceptually unknown or highly problematic.

To illustrate the latter point, reference will be made to the position under Swiss Law. Many parties to turnkey engineering contracts will seek to choose a “neutral” law to govern their contract. Swiss Law is perhaps the most popular. When coupled with English as the contract language this increases the chance that common law wording will be found in such agreements.

The Exclusion Clause

An exclusion clause, as the name suggests, is a provision designed to exclude liability for certain types of damage in the event of a breach of contract on the part of one or more of the parties. Most of such clauses seek to eliminate liability for *consequential* or *indirect* damages. For example:

Neither party shall be liable to the other for any consequential or indirect damages.

Exclusion clauses of this type therefore introduce the concept of two types of damage, direct and indirect, the latter is excluded by this clause. To understand the difference it is necessary to understand where the concepts come from.

The Concept of Damages

Damages are compensation due to a party as a consequence of a loss or expense caused by a breach of contract. A breach of contract arises when one party to the contract fails to comply with one or more of its contractual obligations. That failure may be an obligation to do something or an obligation not to do something. In such circumstances the party to whom the obligation is owed is entitled to damages if he has suffered loss and or incurred expense or has been otherwise harmed. Damages normally mean money- some payment would be owed as a result of the breach.

In common law jurisdictions, unlike in civil law countries, much of the law is to be found in the judgements made by the courts. This “judge made law” sets what is known as “precedents” that must be followed in cases where the facts are identical. The law on direct and indirect damages can be traced back to the seminal case in the English courts of Hadley v Baxendale from 1854. In this case the English courts laid out the classic definition of types of damages that might be due for breaches of contract. The court found that damages due would fall into two types (or limbs as they have become known) that met certain criteria:

The two “limbs”
of Hadley v
Baxendale

*Loss that would be incurred in the usual course of things and
Loss outside the usual course of things that the parties contemplated might
occur if a breach occurred*

The first type of damage has over time become known as direct damages and the second as indirect or consequential. As can be seen from this simple definition the distinction between the two types of damages is somewhat unclear. Indeed, one court may regard as consequential what another regards as direct damages.

Because of this inherent uncertainty and because of the way the common law courts have subsequently developed the principles in Hadley v Baxendale, many common law lawyers will, when drafting exclusion clauses, include a list of the types of damages that are to be regarded as consequential. For example, loss of profits might reasonably be regarded as a loss covered by the second type of damage. However, on a number of occasions the courts have concluded that the facts of the case indicate that loss of profit be regarded as a direct damage, falling under the first limb of Hadley v Baxendale. For this reason, common law lawyers will include loss of profit in their list of exclusions. A typical clause may look like this:

*Neither Party shall be liable for indirect and / or consequential damages
whatsoever such as but not limited to loss of production, loss of profit etc.
caused to the other resulting from undertaking its obligations.*

Damages Under Swiss Law

The default position under Swiss Law is that all damage or loss having an adequate causal link with the damaging event will be claimable. Whether a causal nexus is adequate or not is often left to the equitable judgment of the courts. The Supreme Court in Switzerland has a tendency to consider very remote or indirect causal links as adequate. On its face therefore a contract exclusion clause that purports to exclude consequential damages (without reference to types of such damages) would be regarded as simply restating the principle of adequate causality or would in effect be no limitation at all.

The term consequential damages (Folgeschaden) does not appear in the Swiss Code of Obligations but does appear in case law and doctrine dealing specifically with defects in delivered goods (Mangelfolgeschaden) where the consequential effect of a defect - loss of production, loss of value and the like - are often considered as “consequential”. This area of the law is of particular importance for process plant contractors.

The Net Result

The net effect of the position under English Law, where most of the terminology arises, and the position under Swiss Law is that parties when writing exclusion clauses should agree and list the types of damages to be excluded or waived. Simply relying on the words “consequential” or “indirect” will not be enough to have the desired effect. This is good and recommended practice for all international contracts to avoid (or limit) arguments about what type of damage has been waived and is not claimable.

In our next issue we shall look at drafting exclusion clauses with examples of good practice. The problems of drafting mutual waivers will be discussed - in particular the problem of using lists of “common” damages. We shall also examine how in certain circumstances even the best exclusion clauses may not be effective.

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