Welcome….

to the latest edition of *The Missing Piece*, the monthly legal bulletin from *In House Lawyer*.

In House Lawyer is my individual and exclusive legal service with strong ideals and a bespoke approach.

In this issue I'm continuing the focus on contracts. I'll be explaining the terms which often confuse, namely, direct and indirect losses, advising why you should avoid giving indemnities and how to limit your losses.

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DAMAGES: WHAT CAN THEY GET?

The main remedy in English law for breach of contract is an award of damages. The purpose of damages for a breach of contract is to compensate the injured party for loss, rather than to punish the wrongdoer. The general rule is that damages should (so far as a monetary award can do it) place the claimant in the same position as if the contract had been performed. Generally, there are no rigid rules for the quantification of damages in contract. In the end the assessment of damages is a question of fact. However, there are various principles which affect the damages that will be awarded.

You may hear people refer to a "duty to mitigate losses". This is not a duty enforceable by anyone, rather it is a recognition that if the claimant unreasonably fails to act to avoid or reduce its loss, or unreasonably acts so as to increase its loss its damages recovery will be affected by that failure. For example, an employee dismissed in breach of contract cannot merely sit at home after the dismissal and claim his or her lost wages as damages, but rather the claim is limited to the difference between the wages that would have been paid by the defendant and the wages the claimant could, if he or she had acted reasonably, have obtained by getting a replacement job.

Another principle restricts the recovery of damages which are too remote. The rule in *Hadley v Baxendale* is the leading case on this point. It has two limbs.

> The first limb allows the claimant suffering loss as a result of a breach of contract to recover the losses which arise naturally from the breach of contract, in that the damage is an inevitable consequence of the breach. It is assumed that the parties knew that those losses would occur. This is known as direct loss.
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> The second limb allows the claimant to recover loss that the defaulting party might expect the relevant breach to produce, taking into account its actual state of knowledge (so unlike in direct loss, knowledge is not assumed) and any relevant professional skill or experience. This is known as an indirect or consequential loss.

Though the terms have been defined by the courts in practice, whether a loss is a direct loss or an indirect/ consequential loss is highly context specific. What might be a direct loss in one scenario may be a consequential loss in another. As such it is a question of fact that only the courts can determine. By way of an example, a financial loss resulting from a supply of bricks may be treated differently from a financial loss resulting from the supply of a computer program for calculating tax liability. In the latter case, it could be argued that, as financial saving is one of the key purposes of the product, financial loss is likely to be the most direct loss if the program turns out to be defective. This would not necessarily be the case with bricks where the key purpose in buying them might be to build a store for raw materials. So, in the case of the bricks, financial loss might be regarded as a consequential loss and in the case of the computer program it might be regarded as a direct loss.

Losses can also mutate over time as they become more commonplace, for example, supermarket fines for late/failed deliveries by customers were considered to be indirect losses because they did not flow naturally from the breach but now they have become so commonplace and inevitable that they could be viewed as a direct loss.

TO INDEMNIFY OR NOT INDEMNIFY?

An indemnity is an obligation to compensate someone for some loss or damage by making a money payment. I will often respond to a request by saying that the other side should rely on their right to damages rather than ask for an indemnity. You shouldn't give indemnities easily or lightly.

This is because the general rule is that with an indemnity:

- the rules on the duty to mitigate will not apply, so the losses are likely to be higher than under a claim for damages;
- the courts will not automatically assume that the parties wished to exclude those losses which can't be claimed under *Hadley v Baxendale* and may interpret the word 'indemnity' as an obligation to pay all losses suffered whether or not the loss was in the reasonable contemplation of the parties, so the range of losses will be much wider;
- the claimant only needs to establish that the event triggering the obligation to pay the indemnity has occurred. In an action for damages for breach of contract, it is up to the claimant to establish that both a breach of contract has occurred and that the damages being claimed have, in fact, been suffered. So it's far easier to make a claim under an indemnity.

Practical steps

Where you do give an indemnity, make it subject to certain restrictions, such as:-

- imposing a duty to mitigate;
- limiting the losses to direct losses; and
- where the indemnity relates to a third party that you are notified of any potential claim within a set period and have the 'conduct' of the matter, which means that you are in control of the claim and the negotiation and settlement of it. This is preferable to having the other side deal with the claim with a blank cheque provided by you.

Don't agree to an indemnity for any breach of the agreement by you. You really are hanging yourself out to dry if you do that.

HOW TO LIMIT YOUR LIABILITY

The initial approach to take is to identify the losses you are most worried about and either limit or exclude them regardless of whether they are found to be direct or indirect. If you want to be sure a type of loss is excluded then you need to say so clearly.

As a standard position you should exclude indirect and consequential losses and also exclude the following losses whether they arise directly or indirectly, loss of profit (difficult to insure against), loss of business, loss of goodwill and loss of data.

As well as excluding certain items from your liability you should also limit your liability for various breaches of the agreement. The usual ways to limit liability are a maximum liability per event and an overall cap on liability under the agreement. There are also more industry specific exclusions such as a per tonne cap on product loss in the logistics industry.

You should not accept unlimited liability. You will often get pushback from the other side on this issue. The compromise position you can take is to offer a higher individual limit for specific issues of concern to them or link the limit to the amount recovered under any insurance policy covering that loss.

Wilful misconduct and gross negligence

Gross negligence is where you have been very negligent and wilful misconduct is where you have deliberately done something in breach of the contract. The larger corporates are increasingly asking that these two items be excluded from the limit on liability. That means that any claim which is caused by either event is unlimited. Neither of the terms is defined anywhere and any guidance as to what they mean comes from case law which means that it isn't set in stone and new cases could change the definition during the life of a contract.

Wilful misconduct is a very tricky one to handle. You do not want to be at the risk of an errant employee who decides to go on a frolic of their own. As for gross negligence, if a claim should arise and a customer can claim unlimited losses for gross negligence then rest assured they will strongly argue that you were grossly negligent.

Your first position should be to reject any proposal to insert it into an agreement on the basis that you don't accept unlimited liability. A point I often make is that if you've breached an agreement and then caused them a loss then what difference does it make if it's done intentionally or unintentionally. Why does a moral judgement come into it?

Practical steps

If you have to accept either or both of them then it could be on the basis of:-

- a higher stand-alone limit for those type of claims, but they will nonetheless be limited;
- not leaving the definition of the terms to the mercy of changing case law. You should know at the outset what the risks are in a contract and therefore should propose that the terms are defined in the agreement. For example, define wilful misconduct as the directors deliberately deciding to do something they know will breach the agreement thereby removing the risk of an errant employee.

THAT'S ALL FOR THIS MONTH...

Next month I'll be completing the contracts theme by providing some tips on negotiating contracts. If you have any queries, comments or request for future bulletins then get in touch, I would be delighted to talk to you or meet at your convenience.

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