Consequential Consequences: Contractually Excluding Damages for Lost Profits

July 2018

Services
Construction

Industries
Construction

People
Ryan Krushelnitzky Partner
rkrushelnitzky@fieldlaw.com

Clauses that exclude or limit the recovery of consequential or indirect damages are common in construction, services and other commercial contracts. These clauses can play an important role in risk allocation. This is particularly so in situations where a small breach of contract by one party can result in very significant consequential damages (such as large losses of profits) to another.

Exclusion and limitation of liability clauses often exclude "lost profits" from the types of consequential damages that are recoverable. But, will this type of clause always work to exclude recovery of *any* type of lost profit? As the recent ***Dow Chemical Canada ULC v. NOVA Chemicals Corporation***, 2018 ABQB 482 case illustrates: not always. In summary, in some situations, if the claimed-for "lost profits" can be categorized as "direct damages" instead of "consequential damages", these sorts of standard clauses (which often times focus on lost profits in the context of consequential damages only) will be insufficient to fully exclude recovery of all lost profits.

The Limitation at Issue

The ***Dow*** case arose out of a long-standing dispute between two chemical companies over the operation of a joint venture chemical production facility. The parties claimed and counterclaimed against each other for hundreds of millions in damages, including lost profits. One of the many issues in dispute was whether a limitation of liability clause in the subject contract precluded the recovery of lost profits.

The limitation clause at issue stated that one of the parties (defined as the "Operator") would not be liable for any breaches of contract or tort, unless it acted with gross negligence or willful misconduct, and then only if the damages suffered were not specifically "Excluded Damages".

"Excluded Damages" were defined as "indirect or consequential damages (including without limitation **loss of profits** and damages arising from loss of production)" (among other things). Was this reference to "loss of profits" broad enough to prevent all claims for lost profits?

Are "Lost Profits" Direct or Consequential?

The first question the Court looked at was whether lost profits were "direct damages" or "indirect and consequential damages".

Canadian law distinguishes between "direct damages" and "indirect and consequential damages" based on an English case from the 1800s, known as ***Hadley v. Baxendale***. That case has long been part of the Canadian law of contracts and defines the difference between the two types of damages.

Per ***Hadley***, "direct damages" are the type of damages that fairly and reasonably arise out of the breach of a contract itself, or that may reasonably be supposed to have been in the

contemplation of both parties at the time the contract was made. “Indirect and consequential damages”, on the other hand, are anything else, including damages arising from special circumstances that the parties did not communicate to each other, or damages that would not reasonably have been in the contemplation of the parties as flowing naturally from a breach of the contract.

In ***Dow***, the Court held that “it must surely have been foreseen by the parties that a failure to provide ethylene [i.e. a breach of contract] would result in [one of the parties] suffering loss of profit”. Since these lost profits were found to “arise naturally” from a breach of contract, the Court concluded that- in this case- the lost profits were “direct damages.”

The Court held that the express wording of the limitation clause in ***Dow*** excluded only “loss of profits and damages arising in the context of indirect or consequential damages” (emphasis added). As such, the Court concluded that this clause did not exclude lost profits in the form of direct damages.

Despite contractual language purporting to exclude liability for loss of profits, not all lost profits were excluded. Only those lost profits that were “not objectively or subjectively foreseeable by the parties” were excluded. Those lost profits that "arose naturally", and thus could be categorized as direct damages, were recoverable.

What Does This Mean For You?

Limitation of liability and exclusion clauses can be tricky. Challenging disputes often arise with respect to interpretation, and have the potential for significant adverse consequences.

When negotiating an agreement and desiring to limit recover ability of all types of “lost profits”, great care needs to be exercised in choosing language to do so. If the contract sours, the language chosen will significantly impact how broadly or narrowly the contract’s limitation of liability and exclusion clauses will be interpreted. The more precise the language, the more predictable the outcome, and the less expense and hassle will be involved in resolving the dispute, hopefully in the careful contracting party’s favour.

For advice and assistance with limitation and exclusion clauses, please contact me