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Including exclusion

Gwendoline Davies looks at the courts' changing approach to interpretation of exclusion clauses

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'The Unfair Contract Terms Act (UCTA) can determine the enforceability of clauses which seek to restrict or exclude business liability in some commercial contracts, including the majority of supply contracts.'

The interpretation of exclusion clauses in commercial contracts has continued to prompt disputes and debate over recent months. In this article, I shall be reviewing the courts' changing approach and offer practical advice.

Excluding/limiting liability

A clause intended to exclude or limit a party's liability is often one of the most important provisions within a commercial contract, but the law underpinning such clauses is complex and can be fraught with traps for the unwary.

There are statutory and common law restraints on the ability of parties to limit or restrict their liability and a full understanding of these is crucial in the context of any commercial contract. (The rules on exclusions and limitations are largely the same, except that a limitation is likely to be viewed more favourably by the courts than an outright exclusion of liability.) In particular, for an exclusion clause to be effective, it must be properly incorporated into the contract and it must cover the breach in question (a question of interpretation), taking into account any statutory restraint on the ability to exclude the term (for example, under the Unfair Contract Terms Act 1977 (UCTA) or the Unfair Terms in the Consumer Contracts Regulations 1999).

Contractual interpretation

Generally speaking, if there is any ambiguity in an exclusion clause, the English law principle of *contra proferentem* dictates that the ambiguity is construed against the person who is trying to rely on the exclusion. However, questions of interpretation are rarely straightforward, and several key cases recently have considered the correct approach.

Charting a new course

In *Nobahar-Cookson v The Hut Group Ltd* [2016] the contractual exclusion actually arose indirectly – by virtue of a time-limited notice requirement. The seller's warranties within a share purchase agreement required the buyer to notify the seller of any warranty claim 'within 20 Business Days after becoming aware of the matter'. When the buyer sought to bring a warranty claim, a dispute arose as to whether it was in time. If it was not, the seller's liability was excluded. The Court of Appeal had to determine whether 'aware of the matter' meant:

a) aware of the facts giving rise to the potential claim themselves, even if unaware that those facts might give rise to a claim;

b) aware that there might be a claim; or

c) aware of the claim per se.

The starting point in this interpretation exercise was the wording of the contract itself. Briggs LJ acknowledged that exclusion clauses, in whatever form they appear, inhibit or detract from important obligations or remedies and, as such, may be construed narrowly because the parties are not lightly to be taken to have intended to restrict their rights or remedies in the absence of clear words to that effect. In this particular case, he concluded that the

wording of the exclusion was by no means clear enough to preclude consideration of other factors and aides to interpretation, such as consideration of the purpose of the clause, commerciality and the *contra proferentem* principle. (The court considered that to interpret the clause as meaning that time started running from the moment the buyer was aware there might be a claim would be so open-ended and uncertain as to be entirely uncommercial. The court also considered that the purpose of the clause was to prevent the buyer from pursuing claims which it had kept up its sleeve, and that this purpose was better served by an interpretation which focused on awareness of the claim rather than awareness merely of the facts. Interpretation (c) was therefore found to be correct.)

This case highlights the following legal and practical points:

- It is important to note that exclusions can appear in different forms. For example, any time-limited obligation can amount to an exclusion.
- The starting point in any contractual interpretation exercise should always be the natural meaning of the language itself.
- Where there is ambiguity in the meaning, the court may consider other factors. These can include the background facts, context and underlying purpose of the provision in question; commercial common sense; and legal principles of interpretation such as the *contra proferentem* rule.
- Limitation and exclusion clauses restrict a party's contractual obligations or legal remedies. Parties should not lightly be taken to have limited their rights or remedies without clear wording to that effect.
- As such, although there is no special rule or presumption that exclusion clauses should necessarily be interpreted narrowly (and any such suggestion should be weighed against the important principle of freedom of contract), that may be appropriate in some cases.

In *Transocean Drilling UK Ltd v Provident Resources plc* [2016], the owner of an oil rig contracted with a company to carry out oil-drilling services. The wording of an exclusion clause formed the subject of a dispute when a defect in the rig caused delay to drilling and caused the company to suffer loss. The Court of Appeal concluded that the language of the clause was clear when it came to excluding the particular consequential loss claimed. In addition, these were commercial parties of equal bargaining power and the principle of freedom of contract allowed them to allocate rights, risks and remedies between themselves in any way they chose. Crucially, this was not a case where there was any ambiguity. The lower court had therefore been wrong to apply the principle of *contra proferentem* and to impose a narrow interpretation of the exclusion clause.

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Excluding 'consequential losses'

Commercial contracts often include clauses which seek to exclude liability for what are described in the contract as 'consequential losses'. Remoteness of damage, or 'foreseeability', is an important principle by which English law determines which consequences flowing from a defendant's breach of contract should be compensated in damages. The leading case, *Hadley v Baxendale* [1854], provides that a loss will only be recoverable if it was 'in the contemplation of the parties', and foreseeable losses under the *Hadley* test fall into two 'limbs':

1) Losses arising naturally, according to the normal course of things, from the breach of contract itself (commonly referred to as 'direct' losses).
2) Such losses (commonly referred to as 'indirect' or 'consequential losses') as may reasonably be supposed to have been in the specific contemplation of the particular parties at the time they made the contract, as a probable result of the breach. This second limb covers the particular parties' knowledge of special circumstances at the time the contract was made.

The terminology is, unfortunately, confusing. Plus, the line as to which losses are direct or indirect is not always clear cut and whether a loss is a direct loss or an indirect/consequential loss is context-specific – what might be a direct loss in one scenario may be an indirect/consequential loss in another. (Compare this to the position under US law where, for example, loss of profit is always classed as an incidental or consequential loss, which is generally recoverable.) However a correct understanding of the categorisation of a type of loss can mean the difference between that loss being recoverable in an action for breach of contract, or not.

To further complicate matters, it is all too frequently the case that the types of losses that the parties actually intend to exclude in such clauses are losses which may not fall within the legally recognised *Hadley* second limb definition. (Common examples include loss of profit and loss of use.)

In *Star Polaris LLC v HHIC-Phil Inc* [2016], the contract for the purchase of a ship provided in the exclusion

clause that the defendant shipbuilder would have:

> ... no liability or responsibility whatsoever or howsoever arising for or in connection with any consequential or special losses... unless otherwise stated herein.

The contract also included a 12-month guarantee given by the shipbuilder against all defects due to defective materials, design error, construction miscalculation and/or poor workmanship. When the vessel suffered an engine failure, the shipbuilder contended that its liability was limited, by virtue of the wording of the exclusion clause and the guarantee together, to the cost of repair of physical damage. The purchaser, however, argued that the phrase 'consequential or special losses' should be interpreted narrowly in accordance with the established legal meaning of the losses falling within the second limb of *Hadley*. This rather technical legal distinction was of huge practical significance because the purchaser was claiming for the diminution in value of the vessel, which amounted to a vastly higher sum than the cost of repair, and which would not necessarily be excluded if the purchaser's interpretation of the exclusion clause was correct.

The High Court found for the shipbuilder, and the following key points arise:

- Although there is an historical line of authorities pointing to the *Hadley* meaning and the purchaser's preferred interpretation, the court decided that, taking into account:
  - the whole of the contract;
  - the natural meaning of the wording;
  - the principle of 'freedom of contract'; and
  - the fact that the contract was negotiated between two commercially sophisticated parties,

  the contract demonstrated that the *Hadley* meaning was not the intended meaning of the parties and that the historical line of authorities was therefore not relevant to the case.
- The established meaning of words or phrases, including those such as 'indirect', 'consequential' or 'special losses', is secondary to the wording of the contract itself.
- The particular contract and context are paramount, such that even if the same or similar wording has been construed in a certain way in another case, legal precedent may be of limited value and a court may reach an entirely different conclusion in different circumstances.

UCTA provides, in short, that any attempt to exclude or restrict liability for death or personal injury is void.

This decision is consistent with the modern authorities of *Arnold v Britton* [2015] and *Transocean Drilling*, respectively on contractual interpretation generally and the interpretation of exclusion clauses. It therefore seems to chart a departure from the traditional course that clauses excluding or limiting liability for consequential losses will be interpreted narrowly in accordance with the *Hadley* second limb.

Also of interest during 2017 were the cases of *Persimmon Homes Ltd v Ove Arup & Partners Ltd* and *Crowden v QBE Insurance (Europe) Ltd*, both of which were concerned with exclusion clauses within a professional indemnity insurance policy. In both cases the courts focused on the fact that the clauses were freely negotiated between commercial parties of equal bargaining power and on the clarity of the wording of the clause and its meaning in the context of the contract as a whole. As the court explained further in *Crowden*, insurance exclusions are not simply clauses which aim to exclude liability for negligence or arising otherwise by law or contract; rather, they are clauses which are designed to define the scope of cover provided by the insurance policy overall. In those circumstances, the *contra proferentem* rule must not be applied automatically and may only have a role where the effect of the more straightforward, clear-wording-based construction would be to deprive the policy of a part of the cover that it was clearly intended to provide.

UCTA and an unusual decision

As mentioned above, UCTA can determine the enforceability of clauses which seek to restrict or exclude business liability in some commercial contracts, including the majority of supply contracts. UCTA provides, in short, that any attempt to exclude or restrict liability for death or personal injury is void and that any attempt to exclude or restrict liability for other loss is subject to the 'reasonableness test' (see s11(1) and Sch 2, UCTA).

In *Goodlife Foods Ltd v Hall Fire Protection Ltd* [2017], when Goodlife alleged that Hall Fire Protection was liable for a fire at its factory and claimed over £6m in property and business interruption damages, Hall Fire Protection sought to rely on the contractual provision which excluded all liability for loss caused to:

> ... property, goods, persons or the like, directly or indirectly resulting from our negligence or delay or failure or malfunction of the systems or components provided...

Goodlife, however, argued that the reference to 'persons' was an attempt to exclude liability for death/personal injury which rendered the exclusion clause void.

The High Court judge agreed with Goodlife that the clause included an attempt to exclude or limit liability for death or personal injury but, perhaps somewhat surprisingly, he decided that this did *not* render the whole clause invalid.

Instead, in reliance on an unreported Court of Appeal decision from 1991 (*Trolex Products Ltd v Merrol Fire Protection Engineers Ltd*), the judge found that the part of the clause seeking to exclude liability for death/personal injury could simply be severed, and the remainder could be upheld as enforceable if it passed the UCTA reasonableness test.

The judge went on to find that the remainder of the clause *was* reasonable and therefore enforceable. He placed particular emphasis on the facts that the parties were of roughly equal bargaining position and that the real risk behind this contractual arrangement was the risk of fire damage, which was something that Goodlife could (economically) – and should – have insured against.

The decision in this case was seen by some as surprising because it went against the relatively common reluctance on the part of the courts to leave a party without any remedy at all. However, it is consistent with the emergent approach which we have seen in *Transocean Drilling* and since, that where sophisticated parties enter into contractual terms which very clearly define the exclusions and limitations of risks to which they have agreed, the courts will uphold such exclusions.

Practical advice

Limitation and exclusion clauses restrict a party's contractual rights and obligations or legal remedies and the law fundamentally provides that parties should not lightly be taken to have limited their rights or remedies without clear wording to that effect (although that is not to say that there is any special rule that exclusion clauses should necessarily be interpreted narrowly). Equally, however, freedom of contract is a vital concept within English commercial contract law which allows parties – in particular commercial parties of equal bargaining strength entering into sophisticated contractual arrangements – to apportion responsibility and risk howsoever they see fit.

There is a tension between these apparently competing principles. Combine that with the circumstantial pressure when a costly dispute has arisen and the parties have turned to their contract to ascertain where liability falls, and it is easy to see why exclusion clauses can be highly controversial. To make matters worse, the law in this area is constantly in flux and can often seem contradictory, largely due to the fact that all such cases turn so closely on their own facts and contractual provisions. So what can parties do?

- Parties would be well advised to remember that rarely can a limitation/exclusion of liability clause be absolutely watertight. In many cases, therefore, rather than seeking to exclude all liability in all or any circumstances (and potentially thereby rendering your clause unenforceable altogether), it may be better to accept limited liability in some circumstances to ensure that your clause will stand.

- Key to that process will be for the parties to 'get behind' the contract to try to identify the overall purpose and likely possible risks from the outset, and to really think about how best those risks can be allocated between them or otherwise mitigated (for example, through insurance).

- It is possible, with careful and accurate drafting, to consider precisely what losses are likely to flow from a breach of contract, to categorise them correctly in the context of the particular contract and case, and to deal with them exactly as the parties intend in any exclusion or limitation of liability clause. It is now, more than ever, essential that parties get their drafting right, to ensure that their contracts, and in particular the allocation of risk and liability provisions, properly reflect their intentions.

Parties should not lightly be taken to have limited their rights or remedies without clear wording to that effect.

Established phrases and standard or precedent documents should be used with real caution.

- In addition, where possible limitation/exclusion clauses should be drafted in a series of separate, self-contained provisions, so that, if any part of the clause is found to be void or unreasonable, there is at least a chance that this part can be severed, thereby leaving the remainder of the clause enforceable. ■

Arnold v Britton & ors
[2015] UKSC 36

Crowden & anor v QBE Insurance (Europe) Ltd
[2017] EWHC 2597 (Comm)

Goodlife Foods Ltd v Hall Fire Protection Ltd
[2017] EWHC 767 (TCC)

Hadley & anor v Baxendale & ors
[1854] EWHC Exch J70

Nobahar-Cookson & ors v The Hut Group Ltd
[2016] EWCA Civ 128

Persimmon Homes Ltd v Ove Arup & Partners Ltd & anor
[2017] EWCA Civ 373

Star Polaris LLC v HHIC-Phil Inc
[2016] EWHC 2941 (Comm)

Transocean Drilling UK Ltd v Provident Resources plc
[2016] EWCA Civ 372

Trolex Products Ltd v Merrol Fire Protection Engineers Ltd
(1991) unreported, EWCA, 20 November