

IT BYTES

ANSWERING YOUR COMMON IT CONTRACT LAW QUESTIONS

WHAT IS INDIRECT AND CONSEQUENTIAL LOSS?



WHEN DOES THIS QUESTION TEND TO ARISE?

An important function of many IT contracts is to allocate liability for certain types of loss between the parties. For these purposes, contractual liability provisions commonly distinguish between ‘direct’ losses and ‘indirect’ or ‘consequential’ losses. From a supplier perspective, a typical default position under an IT contract is that the supplier will only be liable for direct losses, and then subject to overarching liability caps and exclusions set out in the contract. Suppliers are generally less willing to accept liability for indirect or consequential losses. The rationale for this position is that anything beyond the direct impact of a breach by the supplier is a business risk that should remain with the customer and not be transferred by contract to the supplier.

To be able to negotiate the allocation of liability for direct vs indirect losses in a meaningful and effective way, it is important to be able to assess the types of losses that will fall into each category in the context of the specific IT contract.

WHAT DOES THE LAW SAY?

The law on indirect and consequential loss in Australia remains unsettled.

The traditional understanding, following an English line of authorities, was based on the rules regarding recovery of damages set out in the famous (at least for lawyers!) case of *Hadley v Baxendale* from 1854. That case established that loss caused by a breach of contract would be recoverable if the loss either:

- arose naturally (i.e. according to the usual course of things) from the breach (the ‘first limb’); or
- could be supposed to have been in the contemplation of both parties, at the time of entering the contract, as the probable result of a breach (the ‘second limb’).

The assumption was that everything within the first limb of the *Hadley v Baxendale* test was ‘direct’ loss, while everything within the second limb was more removed and considered ‘indirect’ loss.

However, recent case law in Australia has cast doubt on that assumption. For example, in *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26 the Victorian Court of

Appeal found that ‘consequential loss’ referred to loss which is not a ‘normal loss’ (interpreted as anything beyond the normal measure, such as profits lost, or expenses incurred through breach). This test potentially excludes a broader scope of losses than under the *Hadley v Baxendale* approach (depending on the circumstances). In *Regional Power Corporation v Pacific Hydro Group Two Pty Ltd (No 2)* [2013] WASC 356 the WA Supreme Court indicated that consequential loss exclusion clauses should be interpreted according to their natural and ordinary meaning in light of the contract as a whole and that the words ‘consequential’ and ‘indirect’ exclude losses that are more removed when considered in the context of the contract as a whole.

In short, as things stand, the way in which references to ‘indirect’ or ‘consequential’ loss within a contract will be interpreted depends on the specific wording and context of the contract in question. In some contracts, references to ‘indirect’ or ‘consequential’ loss may be interpreted broadly so as to encompass losses that may traditionally have been assumed to be ‘direct’ losses - this means that a provision excluding liability for indirect or consequential loss may have a much broader effect than was intended. As a result, parties need to take particular care when drafting and negotiating such exclusions.



WHAT ARE THE IMPLICATIONS FOR YOUR CONTRACT?

Given the uncertainty in the position at law, there are broadly three options for how to deal with defining the scope of indirect and consequential loss in an IT contract (depending on whether you are the supplier or the customer):

1 Simply refer to ‘indirect and consequential loss’ and leave it to the courts to decide how to interpret those terms in the context of your contract should it ever be necessary to do so. This has the advantage of simplicity, but leaves significant uncertainty as to what the effect of your contract will be.

2 Include a specific definition of ‘indirect and consequential loss’ based on the traditional *Hadley v Baxendale* understanding (i.e. by defining indirect and consequential loss as any loss other than loss arising naturally, according to the usual course of things, from the relevant breach).

3 Combine either Option 1 or Option 2 with a list of specific categories of loss that should be excluded in all circumstances (even if they are caused directly by a breach). For example, a supplier will typically seek to exclude loss of revenue or profit, loss of business and loss of reputation or goodwill on the basis that these are inherent business risks that should remain with the customer and which the supplier is not in the position to appropriately manage.

Whether the list of proposed exclusions is acceptable to a customer will depend on the nature of the contract. Exclusions for loss of data (for example) should be carefully considered by a customer depending on the nature of the IT solution being procured. From a customer perspective, it is also important to consider identifying those losses which will not be excluded and expressly setting those out as carve outs to the consequential loss exclusion. For example, the customer may wish to explicitly state that costs incurred in seeking to remedy or mitigate the impact of a breach should not be treated as indirect or consequential loss, and should be recoverable subject to ordinary common law principles.

In all cases, it is important to consider how any exclusion of indirect and consequential loss operates with other liability provisions under the relevant contract. For example, where certain breaches or claims are carved out of general liability caps, it is generally also worth considering whether they should also be carved out of any general exclusion of indirect and consequential loss, so as to allow the maximum recovery of damages permitted under ordinary common law principles.

KEY CONTACTS



KIRSTEN BOWE

PARTNER
BRISBANE

TEL +61 7 3244 8206
MOB +61 409 460 861
EMAIL kirsten.bowe@au.kwm.com



BRYONY EVANS

PARTNER
SYDNEY

TEL +61 2 9296 2565
MOB +61 428 610 023
EMAIL bryony.evans@au.kwm.com



MICHAEL SWINSON

PARTNER
MELBOURNE

TEL +61 3 9643 4266
MOB +61 488 040 000
EMAIL michael.swinson@au.kwm.com

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