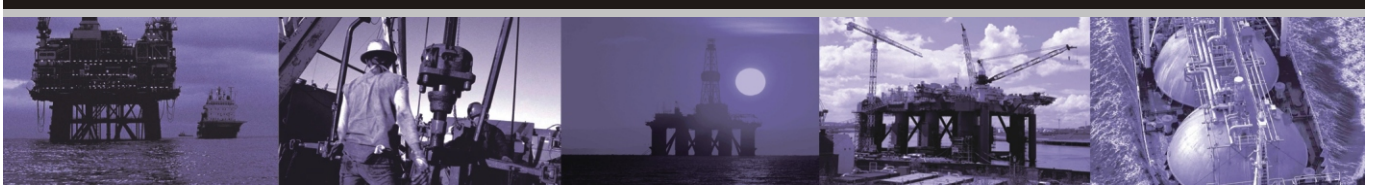


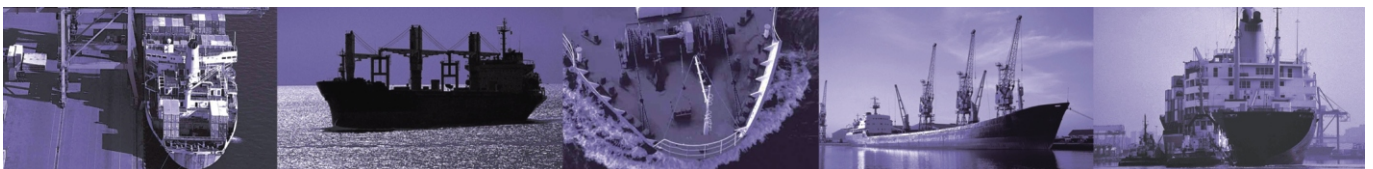


CURTIS DAVIS GARRARD



KEY CONTRACTUAL ISSUES

DAMAGES, LIABILITIES, INDEMNITIES & WAIVER



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Key Contractual Issues Damages, Liabilities, Indemnities, Waiver

We set out below basic principles of English law relating to certain key legal and contractual issues, which will be useful to bear in mind when negotiating or drafting contracts governed by English law. The analysis that follows focuses on the issues of quantification of damages, clauses excluding or limiting liability, indemnities, consequential loss and non-waiver, viewed from an English law perspective.

I. Damages

We start by setting out basic principles relating to the quantification of damages for breach of contract under English law. It should be borne in mind, however, that the application of these principles and the amount of damages ultimately recoverable by the parties will be heavily qualified by, and will depend on, the precise contractual position. Commercial contracts typically provide for limitations or exclusions of liabilities, indemnities, and specify liquidated damages payable or other contractual rights arising in respect of specific breaches. These issues will be addressed later on.

It is a fundamental tenet of English law that an action for damages is a remedy available as of right¹ in case of a breach of contract. An award of damages should compensate the innocent party for his loss, rather than to punish the wrongdoer. However, the type of loss covered will depend on the measure of damages applied in each case. Furthermore, the calculation of damages will be based on different bases of assessment, depending also on the measure applied. Lastly, recoverable damages will be limited by the principles of remoteness, causation and mitigation.

(a) Measure of damages

There are different measures of damages applied depending on the basis of the action. The object of damages for breach of contract is normally to put the aggrieved party in the same situation as if the contract had been performed². This means that the aggrieved party is compensated for the loss of his bargain, such that his expectations in respect of the contract are protected. This is referred to as “expectation loss”. It allows recovery of lost profits which would have been made had the contract been performed.

By contrast, in actions for damages in tort for breach of duty a different measure is applied. The aggrieved party is put into the position it would have been if the breach of duty had not been committed. In other words it is compensated for expenditure incurred or other loss suffered because of such breach. This is referred to as “reliance loss”.

As mentioned above, the measure normally applied in cases of breach of contract is the recovery of expectation loss. However, it may sometimes be more appropriate for the innocent party to claim his reliance loss, i.e. his expenses incurred and losses suffered in reliance on the contract, so as to be put in the same position as if the contract had never been made. This could be the case, for example, where the expectation loss cannot be proved with certainty. Expectation and reliance loss are usually mutually exclusive to prevent double recovery of the same loss. The most appropriate quantification of damages will depend on the circumstances of the case and will ultimately be at the discretion of the judge.

In relation to certain contracts, the applicable measure of damages has been laid down by statute. For example, in contracts for the sale of goods the Sale of Goods Act 1979 (as amended) expressly provides for the measure of damages applicable in various types of breaches of the contract of sale. In particular, in case of wrongful non-acceptance of the goods by the buyer, the measure of damages

¹ To the extent that such right is not expressly excluded or qualified.

² *Robinson v Harman* (1848) 1 Ex 850.

recoverable by the seller is the estimated loss directly and naturally resulting, in the ordinary course of events, from the buyer's breach and, where there is an available market for the goods in question, the measure of damages is prima facie to be ascertained by the difference between the contract price and the market price of the goods at the relevant time³. Analogous provisions apply in respect of damages for wrongful non-delivery of the goods⁴ or breach of warranty by the seller⁵.

In exceptional cases, a party can recover restitutionary damages. Such damages are quantified by reference to the profit made by a party as a result of his deliberate breach of contract in circumstances where it would be unjust to allow him to retain that profit. This may be important if the innocent party is not able to prove his loss.

(b) Bases of assessment of damages

The basis of assessment of the loss will depend on the measure of damages applied.

If the claim is for expectation loss, the claimant can either recover the difference in value between the performance contracted for and the performance rendered or the cost of cure. These two bases of assessment may not necessarily produce the same result (for example, where the difference in value is very small but the cost of cure is substantial⁶). There are no strict rules applied by the courts in deciding whether to use the difference in value or the cost of cure basis and the judge will assess the most appropriate measure of damages in the circumstances.

If the claim is for reliance loss, the basis of assessment is the cost to the claimant of his actions in reliance on the contract.

(c) Remoteness

Under English law, the damages recoverable in case of breach of contract are limited by the rules on remoteness of damage. This means that a claimant cannot recover damages for a loss which is too remote a consequence of the defendant's breach. The basic rules as to remoteness of damage in contract were laid down in the leading authority of *Hadley v Baxendale*⁷. In that case it was decided that the innocent party can recover:

(a) such loss as may fairly and reasonably be considered either as arising naturally, i.e. according to the usual course of things, from such breach of contract itself; (this is known as the first limb of the rule) or

(b) such loss as may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract, as the probable result of the breach, for example where the special circumstances under which the contract was actually made were known to both parties (this is known as the second limb of the rule).

The above test was further elaborated in *Victoria Laundry v. Newman Industries*⁸ where it was held that the test of remoteness is whether the loss was "reasonably foreseeable as liable to result" from the breach and that this is also dependent on the defendant's knowledge: if the defendant had actual knowledge of any special circumstances which would lead a reasonable man to foresee an extraordinary loss, such loss is recoverable. Lastly, in *C. Czarnikow Ltd. v. Koufos (The "Heron II")*⁹

³ Section 50.

⁴ Section 51.

⁵ Section 53.

⁶ See *Ruxley Electronics and Construction Ltd. v. Forsyth* [1996] AC 344, HL.

⁷ (1854) 9 Exch 341.

⁸ [1949] 2 K.B. 528.

⁹ [1969] 1 A.C. 350.

the remoteness test laid down in *Victoria Laundry* was qualified with regard to the degree of foreseeability of the damage required. It was held that for a loss to be recoverable there must be a “serious possibility” or a “real danger” or a “very substantial” probability of such loss. The above rules of foreseeability do not require that the actual loss be contemplated in detail; it is sufficient that the type of the loss incurred was foreseeable¹⁰.

(d) Causation/Mitigation

Further factors to be considered when assessing damages are the principles of causation and mitigation.

The rules relating to causation are complex and sometimes difficult to reconcile. In general, a loss is recoverable only if it was caused by the breach of contract. Therefore, the claimant must prove on a balance of probabilities that the breach caused the loss.

With regard to losses resulting from breach of contract, the Courts have in general avoided laying down any formal tests for causation. Instead, they rely on common sense to determine in each case whether a breach of contract is a sufficiently substantial cause of the plaintiff's loss. The breach must have been the effective or dominant cause of the loss, not just the occasion for the loss¹¹. In other words, the Court must distinguish between a breach of contract which causes a loss to the claimant and one which merely gives the opportunity for him to sustain the loss, and must do so by the application of common sense¹². The breach of contract need not be the sole cause of the loss in question. Thus, if it is one of more causes of the loss, the contract-breaker will be liable as long as the breach was “an” effective cause of the loss¹³. The chain of causation can be broken by an intervening act of a third party or of the claimant.

The duty to mitigate one's loss is a further factor which can limit the extent of damages recoverable by the innocent party in case of breach of contract. The term “duty” is in a fact a misnomer and all it means is that the claimant must take reasonable steps to minimise the loss caused by the breach of contract and, in consequence, cannot recover damages for losses attributable to his failure to mitigate. This rule consists of three different aspects:

- The claimant cannot recover damages for any part of his loss due to the defendant's breach which the claimant could have avoided by taking reasonable steps;
- If the claimant avoids or mitigates his loss resulting from the defendant's breach, he cannot recover for such avoided loss, even though the steps he took were more than could be reasonably required of him under the previous rule; and
- Where a claimant incurs loss or expense in the course of taking reasonable steps to mitigate the loss resulting from the breach, the claimant may recover this further loss or expense from the defendant.

The standard of what the innocent party is required to do when taking reasonable steps to mitigate his loss is not high: he is not under any obligation to do anything other than in the ordinary course of business¹⁴. It is quite usual for the duty to mitigate to be replicated in commercial contracts in the form of a separate contractual obligation. For example, Clause 34.9 of the 1998 CRINE General Conditions of Contract for Marine Construction provides that “[b]oth the COMPANY and the CONTRACTOR shall take all reasonable steps to mitigate any losses resulting from any breach of CONTRACT by the

¹⁰ *The “Heron II”* [1969] 1 A.C. 350; *Christopher Hill v. Ashington Piggeries Ltd.* [1969] 3 All E.R. 1496.

¹¹ *Galoo v. Bright Grahame Murray* [1994] 1 WLR 1360.

¹² *Galoo v. Bright Grahame Murray* [1994] 1 WLR 1360, where it was held that this approach applies in relation to a breach of a duty imposed on a defendant whether by contract or in tort in a situation analogous to breach of contract.

¹³ *Heskell v. Continental Express Ltd.* [1950] 1 All ER 1033.

¹⁴ *Dunkirk Colliery Co. v. Lever* (1878) 9 Ch.D. 20.

other party.” This particular provision seems to simply replicate the duty imposed by general contract law.

However, issues of interpretation may arise if the contract provides that a party is under an obligation to mitigate certain losses, for example costs which are to be borne by the other party. The meaning and effect of such an obligation will be a matter of construction of the particular contract. However, in *Sembawang Corporation Ltd. v. Pacific Ocean Shipping Corporation and Another*¹⁵, the Court had to consider a contract for the conversion of a bulk carrier into a pipelaying vessel. The contract contained a clause which provided that following termination of the contract by the owner, the builder would be liable for the costs and expenses incurred by the owner in the completion of the work elsewhere. The clause also stated that the owner was under the duty to mitigate costs. The Court decided that this did not impose an absolute duty to mitigate costs. The parties, when using the term, had intended the low common law standard of mitigation to apply, i.e. that the owner should take reasonable steps to mitigate the costs in question. Although the Court held that this conclusion was based on the parties’ intentions rather than on any presumption, it seems that it will be difficult to depart from such an interpretation unless the parties’ intentions are made clear in the contract.

A further issue to bear in mind with regard to mitigation is that, unless expressly agreed, the rules of mitigation do not apply to claims for debt due under a contract in return for the claimant’s performance of an obligation. Consequently, a claim for recovery of costs, to the extent that such costs are liquidated, will not be subject to the rules of mitigation, unless there is a contractual provision inserted to that effect¹⁶.

¹⁵ [2004] EWHC 2743 (Comm), 4 November 2004

¹⁶ See the *obiter* comment to that effect made by Mr Justice Gross in *Sembawang Corporation Ltd. v. Pacific Ocean Shipping Corporation and Another*[2004] EWHC 2743 (Comm), 4 November 2004.

II. Limitation/Exclusion of liability

(a) General

Most commercial contracts governed by English law contain clauses purporting to exclude or limit one or both parties' liabilities for breach of either express terms of the contract, or terms implied by statute.

(b) Principles of construction

English courts treat exemption or limitation clauses in a strict manner and construe them against, i.e. in the way least favourable to, the party who is seeking to rely on them. The above rule of construction, known as the *contra proferentem* rule, is applied by the courts with less rigour to clauses which merely limit liability, as opposed to those which totally exclude it. Therefore, in order to be effective, exemption or limitation clauses must be expressed clearly and without ambiguities¹⁷.

In interpreting an exemption or limitation clause, an English court will look at its actual wording to determine whether it covers the specific contingency or loss, for which liability is purported to be excluded or limited. The court will also look at the whole of the contract, so as to construe the clause in question in the context of the contract as a whole, in a manner that is not inconsistent with its purpose and intent. Thus, if the wording of the clause is too narrow or too vague, the court may find that it does not cover the event in question. Conversely, if the scope of the clause is too broad or general, such that it creates an absurdity or defeats the main purpose of the contract or absolves one party from all duties and liabilities, the Court will construe it in a manner that is consistent with the purpose of the contract.

Therefore, although a clause excluding or limiting liability will be examined on its own, it will be construed in the context of the contract as a whole and be read together with other clauses in the contract. For example, there may be other clauses limiting or excluding liability which may weaken, cast doubt or be inconsistent with the clause in question. Moreover, the clause in question may itself include exceptions or limitations to its scope. Consequently, when drafting exclusion or limitation clauses, one should bear in mind the overall scheme of the contract in terms of allocation of risks and liabilities between the parties. Clarity and consistency are crucial.

(c) Excluding or limiting liability for negligence

With reference in particular to clauses excluding a party's liability for negligence, the English courts have developed more specific and stringent rules of construction. The starting point for the courts is the fundamental consideration that it is inherently improbable that a party to a contract should intend to absolve the other from the consequences of the latter's own negligence. Therefore, if such is the intention, it must be made perfectly clear, otherwise the court will conclude that it was only intended for the exempted party to be absolved from liability occasioned from causes other than negligence¹⁸. This principle has led to the formulation of a three-tier test of construction which was laid down by Lord Morton in *Canada Steamship Lines Ltd. v. the King*¹⁹ and which is applicable to both exemption and indemnity provisions²⁰ (as to which see below) but not to limitation clauses. It should be borne in mind that this test amounts to a rule of construction only and not a rule of law:

(a) First, the court must examine whether the exemption clause in question contains an express reference to negligence, in which case it successfully covers negligence. This means that the word

¹⁷ *Ailsa Craig Fishing Co. Ltd. v. Malvern Fishing Co. Ltd.* [1983] 1 W.L.R. 964.

¹⁸ *Gillespie Bros Co. Ltd. v. Roy Bowles Transport Ltd.* [1973] QB 400.

¹⁹ [1952] A.C. 92.

²⁰ *Canada Steamship Lines Ltd. v. The King* [1952] A.C. 192; *Smith v. South Wales Switchgear* [1978] 1 W.L.R. 165.

itself or a word synonymous to it must be referred to in the clause²¹ and until recently, the inclusion of words, such as “whatsoever” was not considered as equivalent to an express reference to negligence²². However, a recent Court of Appeal decision seems to have ruled otherwise (see below).

(b) If the clause fails the first part of the test, the court will then examine whether its wording is wide enough, in its ordinary meaning, to include negligence. If not, then the clause fails the test.

(c) If the wording of the clause is wide enough to cover negligence, the court will proceed to examine whether the loss or damage contemplated in the clause may be based on some legal liability other than in negligence, such as breach of statutory duty, provided, however, that such other liability is not so remote or fanciful that the parties could not have intended the indemnity clause to cover it. If such other legal ground is found to exist, the clause in question will fail the test and the court will find that it does not cover negligence.

With regard to construction of limitation clauses, the English courts follow a less rigorous approach than they do in respect of exemption clauses or indemnity provisions. It seems that it is enough that such clauses are clear and unambiguous. In *Ailsa Craig Fishing Co. Ltd. v. Malvern Fishing Co. Ltd.*²³ it was held that the strict principles laid down in the three-tier test formulated by Lord Morton, which apply to exclusion and indemnity provisions, are not applicable to limitation clauses. Although limitation clauses must be clearly expressed and will be construed *contra proferentem* there is no justification for them being assessed by the principles applying to exemption and indemnity clauses.

(d) The Unfair Contract Terms Act 1977

A further dimension to bear in mind in dealing with exemption or limitation clauses is that under English law, their validity is also subject to statutory control by the Unfair Contract Terms Act 1977 (UCTA). UCTA applies to clauses which seek to restrict or exclude business liability, but it is expressly not applicable to a broad range of contracts of an international nature²⁴. To the extent that it applies, it makes the clause in question, depending on its nature, either wholly ineffective or subject to a requirement of reasonableness.

²¹ *Smith v. South Wales Switchgear* [1978] 1 W.L.R. 165 at 169, 173.

²² *Smith v. South Wales Switchgear* [1978] 1 W.L.R. 165 at 169, 173.

²³ [1983] 1 W.L.R. 964 (HL). See also *George Mitchell (Chesterhall) Ltd. v. Finney Lock Seeds Ltd.* [1983] 2 AC 803.

²⁴ The excepted contracts include “international supply contracts” as defined in section 26 of the Act and contracts which are governed by English law (or the law of any other part of the UK) only by choice of the parties, as defined in section 27 of the Act. They also include a list of contracts set out in Schedule 1 to the Act.

III. Indemnity Schemes

(a) General

Among the standard provisions in offshore contracts there will be detailed mutual indemnity/hold harmless clauses covering liabilities of the parties in respect of loss or damage to their respective property and death or personal injuries to their respective employees. Given the size of oil and gas projects and the number of people involved, the potential liabilities to which the parties may be exposed, especially in case of a disaster, are enormous and although insurance arrangements will usually be in place, the best way for the parties to address such liabilities is to provide beforehand, in the contract itself, which party will bear which type of loss, so as to allocate the insurable risks more effectively.

The usual way of dealing with this is to provide that each party will bear the liabilities for loss or damage to his property and for death or personal injury to his employees caused by the other party. Thus, each party bears the risk and costs of any losses or damage to property and/or deaths and personal injuries which may occur to his "side". Depending on the individual agreement, this will usually encompass each party's property/items and employees and may extend to his subcontractors or sub-subcontractors and their respective property and employees. Thus, for the purposes of these schemes, each side usually encompasses the respective party's affiliates and subcontractors. In addition, the parties usually include a regime dealing with liabilities to third parties, which are usually defined as those parties who are unconnected with the project. One of the usual arrangements is for each party to be responsible for losses or damage caused by his own negligence.

Such "knock-for-knock" indemnity schemes are given effect by the English Courts, but their precise scope and effect will be a matter of construction. Careful drafting is therefore important. The liabilities which normally arise in the context of an offshore project (and which are usually covered by indemnity "knock-for-knock" schemes) are tortious liabilities, in particular liabilities in negligence (breach of a duty of care), but may also be liabilities imposed by statute (breach of a statutory duty), which are normally strict liabilities incurred irrespective of fault, or even contractual liabilities.

It is important that the indemnity clauses contain as clear provisions as possible with regard to the allocation of the various risks as between the parties. Issues that may arise in relation to their scope and effect relate to the type of liability covered and to the persons and property covered by the relevant clause. For example, as regards loss or damage to property, it is best to define clearly what constitutes each party's property or "items", which may well include in each case equipment hired or leased from third parties. As regards death or personal injury caused to each party's employees, it should be made clear whether the indemnity provisions also cover subcontractors' employees.

Care must be taken with regard to the liabilities to third parties covered by such indemnity schemes. Strictly speaking, on the basis of the principle of privity of contract, the term "third parties" would include not only third parties totally unconnected with the project, but also the contracting parties' subcontractors and their respective employees, as well as their sub-subcontractors. Usually, separate regimes apply in respect of the parties' subcontractors and third parties entirely unconnected with the project. In such case, it is important that there is a clear definition in the contract of the term "third parties". Subcontractors may be expressly mentioned in the indemnity provisions or simply be included in the definition of "Contractor Group" or "Company Group". Obviously, these issues will be crucial with regard to the allocation of risks and liabilities between the parties. It is interesting to note, for example, that in the 1998 CRINE General Conditions of Contract for Marine Construction the definition of the "CONTRACTOR GROUP" includes the Contractor's subcontractors and affiliates, whereas the definition of the "COMPANY GROUP" does not include any subcontractors. On the other hand, in Clause 22.1(c) of the same Conditions "third party" is defined as "*any party which is not a member of the CONTRACTOR GROUP or the COMPANY GROUP*" with similar wording included in Clause 22.2(c).

Given that “knock-for-knock” schemes are concerned with allocation of risks, they also invariably contain insurance provisions, which usually stipulate that the party who is to bear the risk must also insure against it. The obligation to insure is sometimes coupled with the undertaking by the party providing the indemnity to procure or simply to use best endeavours to procure that the insurers will not exercise their rights of subrogation against the party who is to benefit from the indemnity.

(b) Rights of Third Parties

A further issue which should be borne in mind is the fact that such indemnity provisions are typically couched on such terms as to include in their protection a wide range of persons and entities outside the parties who have signed the contract, notably the parties’ affiliates and subcontractors and their employees. An example of this can be found in Clause 22.1 of the 1998 CRINE General Conditions of Contract for Marine Construction, which provides that the Contractor shall indemnify the Company Group (rather than the Company only), which Group includes the Company’s affiliates and co-venturers. Previously, under English law, the doctrine of privity of contract did not permit the parties to a contract to confer enforceable rights (or to impose burdens) on a third party, i.e. someone who is not party to their contract. Therefore, any third parties included in the protection provided by indemnity schemes could not enforce the indemnity granted to them directly against the party granting it in the contract.

However, this rule has been amended by the introduction of the Contract (Rights of Third Parties) Act 1999 (Third Parties Act). The Third Parties Act permits a third party to enforce rights granted to him under a contract to which he is not a party in certain circumstances²⁵. This is possible for third parties even if they are not individually identifiable or not yet in existence at the time of the contract, provided that it is possible to describe them as members of a class. Thus, in the context of an indemnity, a reference to a party’s subcontractors or affiliates would be sufficient for these purposes. To take an example, in the case of an indemnity under Clause 22.2 of the 1998 CRINE General Conditions of Contract for Marine Construction, a Contractor’s subcontractor (being part of the Contractor Group) facing a claim from a member of the Company Group for damage caused to that member’s property can claim directly from the Company an indemnity against that liability. The Company Group member can still bring his claim against the subcontractor that caused the damage but the subcontractor can enforce his indemnity directly against the Company without the need to involve the Contractor.

However, the Third Parties Act also contains provisions which can be burdensome to the parties to the contract. For instance, it provides that where a third party has a right to enforce a term of a contract, the parties to that contract cannot rescind or vary the contract in a way that adversely affects the third party’s right without his consent in circumstances where such right has “crystallised”. Therefore, in relation to indemnity schemes in offshore contracts, the parties should consider carefully the issue of the application of the Third Parties Act in the contract. If they exclude its application altogether, they will be unable to use its mechanisms for direct enforcement of indemnity rights by a broad range of third parties. If they do not, they may be faced with the difficulties mentioned above. Alternatively, the parties may include a provision to the effect that the parties may rescind or vary the contract without the consent of any third party, even if this affects such other party’s right to enforce a term.

(c) Principles of construction

As mentioned above, the courts treat indemnity provisions in the same way as they treat exemption clauses and the same principles of construction apply to both types of clauses. In general, all such clauses are to be construed *contra proferentem*, that is against the party seeking to rely on them. Again, as with exemption clauses, the precise scope and effect of an indemnity clause will be derived from the wording of the clause itself having regard to the scheme of which it forms part and the

²⁵ However, the Act does not permit the contracting parties to impose burdens on third parties.

contract as a whole²⁶. Thus, if the contractual language contained in the clause is sufficiently clear to indicate the intention of the parties, the court will give effect to it²⁷. If not, the court will assess the scope and effect of the clause in question with regard to the other provisions of the indemnity scheme and the contract as a whole.

(d) Liability for negligence

The principles of construction developed by the English courts to determine whether a clause effectively excludes a party's liability for his own negligence, including the three-tier test set out above, are also applied to indemnity provisions. An example of the application of this three-tier test in the offshore sector can be found in the leading case of *E.E. Caledonia Limited v. Orbit Valve Co.*²⁸ which relates to the Piper Alpha disaster. The case concerned a contract between the operators of a drilling platform (claimants) and the contractors for the supply of a service engineer to carry out work on the platform (defendants). A fire on the platform caused by the negligence and breach of statutory duty of the operators' employees resulted in the death of the contractors' engineer. The operators sought an indemnity from the contractors in respect of the amount they paid to settle the claim made against them by the engineer's estate. The relevant indemnity clause in the contract provided that each party should indemnify the other "*provided that the other party ha[d] acted in good faith*" against "*any claim ... or liability ... arising by reason of ... death of any employee of the indemnifying party, resulting from or in any way connected with the performance of this order*".

Both the Commercial Court and the Court of Appeal found that the indemnity clause failed to cover the operators' negligence. Applying Lord Morton's three-tier test they found, in particular, that (a) the clause did not contain an express reference to negligence, but that (b) its wording was wide enough to cover it. However, (c) the liability for which the claimants sought to be indemnified could be based on grounds other than negligence, such as breach of strict statutory duty, and such alternative grounds were not fanciful or remote.

However, *Caledonia* was distinguished by the Court of Appeal in *Brown v. Drake International Ltd. and Southampton Container Terminals*²⁹, a case which also concerned the application of an indemnity clause. The claim was for damages for the death of an employee of the first defendant who was fatally injured while working at premises operated by the second defendant. The contract between the two defendants contained an indemnity clause which provided that the first defendant was to indemnify the second defendant "*from and against all liability for personal injury (whether fatal or otherwise), loss of or damage to property and other loss, damage, costs and expenses however caused or incurred which arise out of or in connection with the execution of the Contract.*"

On the basis that both defendants had been negligent and in breach of statutory duty, the Court of Appeal considered whether by virtue of the clause the first defendant was to indemnify the second defendant for his share of liability to the claimant. In applying the three-tier test, the Court held that the presence in the clause of the words "however caused or incurred" distinguished the case from the *Caledonia* case. These words were wide enough to exclude liability for negligence and breach of statutory duty. Their inclusion meant that the three-tier test was satisfied at the first stage and that the court's enquiry did not need to go beyond that. This seems to be in contrast with other authorities, according to which a clear and unmistakable reference to negligence or to a synonym for it is required for the first tier of the test to be satisfied³⁰.

²⁶ *Smith v. South Wales Switchgear* [1978] 1 W.L.R. 165, 168; *The "Raphael"* [1982] 2 Lloyd's Rep. 42; *Breaveglen Ltd. v. Sleeman Ltd.*, (unreported) Court of Appeal (Civil Division) 9 May 1997.

²⁷ In *Photo Production Ltd. v. Securicor Transport Ltd.* [1980] A.C. 827, 851 it was held that "*in commercial contracts negotiated between businessmen capable of looking after their own interests ... it is ... wrong to place a strained construction upon words in an exclusion clause which are clear and fairly susceptible of one meaning only ...*".

²⁸ [1994] 2 Lloyd's Rep. 239.

²⁹ [2004] EWCA Civ. 1629, 03.12.2004.

³⁰ *Smith v. South Wales Switchgear* [1978] 1 W.L.R. 165. See above.

In conclusion, the safest way of drafting an indemnity clause, so as to ensure that liability arising from negligence will be covered, is to make express provision to that effect. An example of this can be found in Clause 18.1 of the 1997 CRINE General Conditions of Contract for Mobile Drilling Rigs, which stipulates that all the indemnities and exclusions set out therein “*shall apply irrespective of cause and notwithstanding the negligence, breach of duty (whether statutory or otherwise) or other failure of any nature of the indemnified party...*”³¹. However, in light of the recent decision in *Brown v. Drake*, the inclusion of wide words, such as “however caused or incurred”, when referring to the grounds of liability covered may be sufficient. It remains to be seen how this latest authority will be evaluated by future judgments.

Indemnity provisions often include a carve-out of liability for gross negligence, i.e. the indemnity granted is to apply unless where the loss of or damage to property or the death or personal injury was not caused by the gross negligence of the party which is being indemnified. As a matter of principle, English Courts have not in the past recognised a distinction between “gross” and “simple” negligence³².

However, the meaning of “gross negligence” was more recently considered in *Red Sea Tankers Ltd. and Others v. Papachristides and Others (The “Hellespont Ardent”)*³³. Examining the meaning of “gross negligence” in the context of agreements which were subject to New York law, Mance J. stated that, whether viewed in the light of the New York authorities or in the context of its simple grammatical meaning, the concept of gross negligence was “*serious negligence amounting to reckless disregard, without any necessary implication of consciousness of the high degree of risk or the likely consequences of the conduct on the part of the person acting or omitting to act*”. He went on to say that if the matter was viewed according to purely English principles of construction, he would reach the same conclusion. Although this judgment did not cite or consider the previous authority of *Pentecost*, it is a relevant authority for the meaning of “gross negligence” in this type of clauses.

(e) Breach of express contractual term

A further issue that the English courts have had to determine is whether an indemnity clause can be construed so as to cover even the consequences of a party’s own breach of contract. According to general principles, an exemption or indemnity clause can even cover the consequences arising out of a party’s breach of contract provided that the intention of the parties is clear enough to allow such a construction³⁴.

This issue, however, was specifically addressed in the leading case of *Deepak Fertilisers and Petrochemicals Corporation v. ICI and Others*³⁵. That case concerned a contract for the supply of technology and know-how for the construction, operation and maintenance of a methanol plant in India between Deepak, the owners of the plant, and Davy, the licensees of technology and know-how owned by ICI. Due to, amongst other things, breach of the plant contract by Davy, an explosion occurred in the plant causing severe damage to it and bringing the production to a halt. Deepak claimed damages against Davy, who argued that the indemnity provisions in the plant contract provided a complete defence against Deepak’s claims, as they were wide enough to cover all claims, contractual or tortious. The relevant clause provided that Deepak was to indemnify and hold Davy harmless “*from and against any and all liabilities for... loss or damage to the property of Deepak ...*”.

³¹ The wording of the corresponding provision in the 1998 CRINE General Conditions of Contract for Marine Construction is different.

³² *Pentecost v. London District Auditor* [1951] 2 KB 759.

³³ [1997] 2 Lloyd’s Rep. 547.

³⁴ *Photo Production Ltd. v. Securicor Transport Ltd.* [1980] A.C. 827, 851; *Deepak Fertilisers v. ICI* [1999] 1 Lloyd’s Rep. 387, 393 (C.A.).

³⁵ [1998] 2 Lloyd’s Rep. 139.

Rix J. held that in the absence of express language covering the matter or unless the logic of the clause and contract otherwise compels such a construction, an indemnity clause such as the above should not be construed as intending to protect a party against a liability which was due to a breach of his own contractual obligations, whether such obligations lie in negligence or are strict obligations. He added that Lord Morton's guidelines should apply with even greater force to an indemnity provision purportedly protecting against the consequences of breach of contract.

An example illustrating the interaction of the above principles and the importance of clear allocation of risks between the parties is the case of *Smedvig Ltd. v. Elf Exploration UK plc*³⁶. Here, a drilling contract between Smedvig and Elf contained detailed reciprocal liability and indemnity provisions in respect of claims as between Smedvig and Elf for damage to Smedvig's and Elf's respective "items". It also contained separate provisions whereby Smedvig was to be liable and indemnify Elf in respect of claims for damage to property brought by third parties against Elf. All these provisions specifically covered negligence.

During the drilling operations a remote operation vehicle hired by Elf from a third party (STS) was damaged due to a collision with Smedvig's drilling unit. STS issued proceedings against Smedvig for the physical damage to the vehicle and consequential loss on the basis that the damage was caused by the negligence of one of Smedvig's employees. Smedvig was found liable and sought to be indemnified by Elf under the indemnity provisions governing liability as between Smedvig and Elf in respect of damage to Elf's "items". Although hired from STS, the vehicle in question was such an item under the contract. Elf argued that Smedvig was in breach of a separate clause in the contract which provided that Smedvig was to take all necessary care of Elf's "items" and that although the indemnity provision invoked by Smedvig covered negligence, it could not be construed so as to cover Smedvig's breach of contract. Elf sought instead to rely on the provision which stipulated that Smedvig was to be liable for and indemnify Elf against third party claims.

The Court dismissed Elf's arguments and looking at the contract as a whole, he found that "[t]here was clearly not only an intent of the parties to provide for obligations on the part of each but also an intent to allocate risk in specified circumstances irrespective of fault." He stated that he regarded these clauses as "part of a clear contractual regime" and that it was "clear that the parties ha[d] gone out of their way to distinguish liabilities between themselves inter se and liabilities to third parties". He added that the allocation of risks between the parties did not render Smedvig's contractual obligations for safekeeping of Elf's items redundant or unenforceable and concluded that the claim against Smedvig for damage to the vehicle fell within the scope of the indemnity provided by Elf as part of the reciprocal indemnity scheme.

³⁶ [1998] 2 Lloyd's Rep. 659. This case was decided before publication of the appeal judgment on Deepak and no reference to the principles set out in Deepak were made in the judgment.

IV. Liability for consequential loss

The term “consequential”, or, alternatively, “indirect” loss or damage³⁷ (used in contradistinction with “direct” loss or damage) is frequently encountered in commercial contracts in the context of limitation or exclusion of liability clauses or in the context of indemnity provisions. Clauses excluding or limiting a party’s liability for consequential loss or indemnifying the other party against such liability are invariably included in commercial contracts used in the offshore sector³⁸.

Despite the wide use of the term in contractual exclusion clauses, there is a fair amount of confusion regarding its meaning and its distinction from “direct” loss. When commercial people use the term, they usually refer to the “knock-on effect” losses flowing from a breach of contract, notably loss of profits, loss of production, loss of business etc.

However, as a matter of English law, the distinction between direct and indirect or consequential loss relates to the rules of remoteness of damage (as to which see above). In particular, it has been held that “the line between direct and indirect or consequential losses is drawn along the boundary between the first and second limbs of *Hadley v Baxendale*”³⁹. In *Croudace Construction Ltd. v. Cawoods Concrete Products Ltd.*⁴⁰ it was established that the word “consequential” does not cover any loss which directly and naturally results in the ordinary course of events from the breach of contract i.e. the first limb of the rule of *Hadley v. Baxendale*.

Dealing in particular with loss of profits, several judicial authorities since *Croudace* have established that “loss of profits” is prima facie an example of direct loss⁴¹ and that “loss of production” or “loss of business” are merely variations on that theme⁴². Accordingly, a general exclusion of liability for “indirect” or “consequential” losses will only exclude loss of profit if such loss was, according to the above rules of remoteness, only claimable under the second limb of *Hadley v. Baxendale*.

Consequently, from a drafting point of view, exclusion provisions should treat items such as loss of profits, production, goodwill, business opportunity etc., as separate categories of excluded loss rather than as an example of consequential loss. An example of such drafting can be found in Clause 25 of the 2003 CRINE General Conditions of Contract for Construction.

³⁷ These two terms are used interchangeably and are treated by judicial authorities as synonymous.

³⁸ An example of this is Clause 25 of the 1998 CRINE General Conditions of Contract for Marine Construction.

³⁹ *BHP Petroleum Ltd v British Steel plc* [1999] 2 Lloyd’s Rep. 583.

⁴⁰ [1978] 2 Lloyd’s Rep. 55.

⁴¹ *Deepak Fertilisers v. ICI and Others* [1999] 1 Lloyd’s Rep. 387 (C.A.)

⁴² *BHP Petroleum v British Steel plc* [1999] 2 Lloyd’s Rep. 583.

V. Waiver/Estoppel

The term “waiver” is used in English law in a variety of situations. It signifies a party relinquishing some or all his rights under a contract either by way of variation of the contract (where such relinquishment is supported by consideration from the other party) or by way of abandonment of a right which arises through making an election or by way of forbearance from exercising a right. The latter is the context in which the term “waiver” is mostly used. Broadly speaking, the effect of such forbearance is that where a party has actually accepted a varied performance of an obligation by the other party (for example, late delivery) it cannot then claim damages on the ground that performance was not in accordance with the original contract. Waiver may thus be used in the sense of a variation to the terms of the contract which either is not supported by consideration or does not comply with the necessary formalities, for example it occurs orally in a type of contract which is required to be in writing. It may also be that a party waives the right to terminate the contract due to a repudiatory breach which goes to the heart of the contract without waiving his right to sue for damages.

The waiver may be written, oral or may be simply inferred from conduct. In *Plasticmoda Societa per Azioni v. Davidsons (Manchester) Ltd.*⁴³ it was described by Lord Denning MR as follows:

“If one party, by his conduct, leads another to believe that the strict rights arising under the contract will not be insisted upon, intending that the other should act on that belief, and he does act on it, then the first party will not afterwards be allowed to insist on the strict legal rights when it would be inequitable for him to do so.”

In *W.J. Alan & Co. v. El Nasr Export*⁴⁴ Lord Denning added that the party who acts on the belief so induced by the party granting the waiver does not need to suffer any detriment, but simply to have conducted his affairs on the basis that he has that benefit, such that it would be inequitable now to deprive him of it. The requirement that the party to whom the waiver was granted must have acted to his detriment seems to be an open question⁴⁵ but most authorities seem to support Lord Denning’s view⁴⁶. The effect of waiver is that the party who forbears will be bound by the waiver and cannot enforce against the other party the original terms of the agreement. Thus, if by words or by conduct such party has agreed or led the other party to believe that he will accept performance at a later date or in a different manner than that stipulated in the contract, he will be unable to refuse such varied performance when tendered⁴⁷. It appears, however, that – unlike an agreed variation – forbearance in the form of a waiver can generally be revoked by giving reasonable notice to the other party that the strict legal rights will be relied upon⁴⁸.

A similar concept is the doctrine of promissory or equitable estoppel, developed by equity. The principle was first stated by Lord Cairns in *Hughes v. Metropolitan Railway* (1877) 2 App. Cas. 439: “... if parties who have entered into definite and distinct terms ... afterwards by their own act or with their own consent enter upon a course of negotiation which has the effect of leading one of the parties to suppose that the strict legal rights arising under the contract will not be enforced, or will be kept in suspense, or held in abeyance, the person who otherwise might have enforced those rights will not be allowed to enforce them where it would be inequitable having regard to the dealings which have thus taken place between the parties.” Equitable estoppel requires a clear and unequivocal representation by words or conduct that a party does not intend to exercise his legal rights, in reliance on which the

⁴³ [1952] 1 Lloyd’s Rep. 527.

⁴⁴ [1972] 2 QB 189.

⁴⁵ See per Stephenson L.J. in *W.J. Alan & Co. v. El Nasr Export* [1972] 2 QB 189; see also *Bremer Handelsgesellschaft Schaft MBH v. Vanden Avenne Izezem PVBA* [1978] 2 Lloyd’s Rep. 109.

⁴⁶ *Youell and Others v. Bland Welch & Co. Ltd. and Others (The “Superhulls Cover” case)(No.2)* [1990] 2 Lloyd’s Rep. 431.

⁴⁷ *Plasticmoda Societa per Azioni v. Davidsons (Manchester)* [1952] 1 Lloyd’s Rep. 527; *Panoutsos v. Raymond Hadley Corpn of New York* [1917] 2 KB 473.

⁴⁸ *Bentsen v. Taylor, Sons & Co.* [1893] 2 QB 283.

other party acts or refrains from acting, such that it would be inequitable for the party making the representation to enforce his legal rights in a manner inconsistent with that representation⁴⁹.

Waiver and equitable estoppel are complex doctrines and, although they are very similar (for example, in both cases the representation – be it by words or conduct – must be clear and unequivocal⁵⁰, although this does not mean that it must be express, it may just be implied), there are also differences between them. Thus, it has been held that one of the elements of the common law waiver is that it requires knowledge by the party waiving a right of the facts giving rise to such right, although this seems only to apply where the waiver is in the nature of an election. Moreover, once the election has been made, there is no requirement for the other party to rely on it. In contrast, equitable or promissory estoppel requires that the party to whom forbearance was granted acts in reliance on that⁵¹. However, despite the inconsistencies in the terminology, the two concepts are treated by the courts as essentially similar and are often used interchangeably⁵². It is important to note that the conduct of the party waiving or being estopped is viewed objectively, i.e. what matters is its effect on a reasonable person in the position of the other party⁵³, and the determination as to whether there has been a waiver will be made by reference to all prevailing circumstances⁵⁴. Therefore, a party must be careful as to his conduct following another party's breach and as to what inferences may be drawn from such conduct.

A variation of the above principles is the doctrine of estoppel by convention, which arises where both parties to a transaction act on an assumed state of facts or law. In particular, it involves an agreed assumption, whether of fact or law, which each party knows is held by the other and which forms the basis on which they have subsequently conducted their dealings so as to make it unjust to allow either of them to challenge the assumption later on⁵⁵. The assumption is either shared by both or made by one party (even by mistake) and acquiesced in by the other. Therefore, communications between the parties are essential in this respect. The parties cannot then deny the truth of that assumption if it would be unjust or unconscionable to allow either of them to go back on it.

Estoppel by convention differs from other types of estoppel in that it does not depend on a clear and unequivocal representation or promise. Its effect is that it precludes a party from denying the agreed or common assumption of fact (for example that a promise was made), or as to the meaning of a document or of law (which seems to include assumptions as to the construction of a contract). During the course of a project it is not uncommon for obligations or breaches by one party to be waived by the other. Such waivers may occur expressly or be inferred from a party's conduct. Given the complexity of the above principles, a non-waiver clause is often included in commercial contracts, in order to protect the parties against the consequences of inadvertent forbearance of breaches or of obligations by the other party. An example of such a provision is Clause 34.1 of the 1998 CRINE General Conditions of Contract for Marine Construction.

There is no direct authority on whether clauses of this type are effective. The best practice would be not to rely entirely on them and, in the event of a breach, especially where such breach is recurring, to put the party in breach on notice, require that the breach be remedied and reserve one's rights.

⁴⁹ *Motor Oil Hellas (Corinth) Refineries S.A. v. Shipping Corporation of India (The "Kanchenjunga")* [1990] 1 Lloyd's Rep. 391.

⁵⁰ *Motor Oil Hellas (Corinth) Refineries S.A. v. Shipping Corporation of India (The "Kanchenjunga")* [1990] 1 Lloyd's Rep. 391; *Woodhouse AC Israel Cocoa Ltd. SA and AC Israel Cocoa Inc. v. Nigerian Produce Marketing Company Ltd.* [1972] 1 Lloyd's Rep. 439.

⁵¹ *Motor Oil Hellas (Corinth) Refineries S.A. v. Shipping Corporation of India (The "Kanchenjunga")* [1990] 1 Lloyd's Rep. 391.

⁵² See e.g. *Youell and Others v. Bland Welch & Co. Ltd. and Others (The "Superhulls Cover" case)(No.2)* [1990] 2 Lloyd's Rep. 431.

⁵³ *Bremer Handelsgesellschaft Schaft MBH v. Vanden Avenne Izegem PVBA* [1978] 2 Lloyd's Rep. 109; *Bremer Handelsgesellschaft Schaft MBH v. C. Mackprang Jr.* [1979] 1 Lloyd's Rep. 221.

⁵⁴ *Bremer Handelsgesellschaft Schaft MBH v. C. Mackprang Jr.* [1979] 1 Lloyd's Rep. 221.

⁵⁵ *Norwegian American Cruises A/S v Paul Mundy Ltd (The 'Vistafjord')* [1988] 2 Lloyd's Rep. 343; *Amalgamated Investment & Property Co. Ltd v Texas Commerce International Bank Ltd* [1982] 1 Q.B. 84

VI. Good Faith – Material Breach

Two further issues are worth mentioning as they relate to recurring problems in commercial contracts.

The first one relates to the principle of good faith. It is frequent for parties to insert provisions in the contract to the effect that they are to conduct negotiations in good faith in order to reach agreement on a specific issue relating to the contract. Unlike many jurisdictions, the doctrine of good faith is not recognised in English law and the leading authority on the enforceability of agreements to negotiate is *Walford v. Miles*⁵⁶ where the House of Lords held that an agreement to negotiate is not recognised as an enforceable contract. The Court held that the reason why an agreement to negotiate, like an agreement to agree, is unenforceable, is simply because it lacks the necessary certainty. It also held that the concept of a duty to negotiate to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations and that each party to the negotiations is entitled to pursue his own interest, so long as he avoids making misrepresentations. A duty to negotiate in good faith is as unworkable in practice as it is inherently inconsistent with the position of a negotiating party.

However, that case related to negotiations between parties at a pre-contract stage in order to reach agreement. In *Petromec v Petroleo Brasileiro S.A. Petrobras and Another*⁵⁷ the Commercial Court examined the enforceability of such an agreement when included as a term in an enforceable contract. The clause in question provided that the parties would negotiate in good faith to reach agreement on certain amounts of costs for the upgrade of a semi-submersible oil production platform which were payable to one of the parties under a separate clause in the contract. The Court held that this type of situation was different from the pre-contract negotiations addressed in *Walford v. Miles* but that while the process remained one of negotiations, the fundamental objections still applied, as the ultimate object of the negotiations was to reach agreement and it would still be impossible to identify the content of such agreement. Such an agreement was not enforceable because of the uncertainty of the outcome of such negotiations. Even if an obligation to negotiate in good faith were recognised in cases where it forms part of an agreement, a breach of such obligation would not enable the innocent party to recover the benefit of the bargain (if any) to which the *bona fide* negotiations would have led because the very existence of such bargain and its terms would always remain uncertain. However, the Court of Appeal, although dealing with the issue on an *obiter* basis, left room for change on this point and held that the fact that the obligation to negotiate in good faith is made part of a complex agreement is relevant and “it would be a strong thing to declare unenforceable a clause into which the parties have deliberately and expressly entered.” It concluded that *Walford v. Miles* was not binding in relation to a such an express obligation to negotiate.

The second issue is the concept of “material breach”. Very frequently, offshore projects contain express termination provisions on the ground of “material breach” of the contract by one or both parties. This term is not a term of art under English law and whether a party to a contract has committed a material breach will be a question of fact, which will depend on the facts of the particular case. Usually, however, it will be difficult to make such an assessment and the use of this term in contracts is a source of uncertainty and disputes. The term should be distinguished from the old doctrine of “fundamental breach”, now an abolished doctrine, according to which if a party committed a fundamental breach of contract he could not avail himself of any exceptions or limitations of liability contained in the contract in his favour. It should also be distinguished from the term “repudiatory” breach, which under general contract law, refers to a breach which goes to the root of the contract or deprives the innocent party from substantially the whole of its benefit, thus entitling the innocent party to treat the contract as discharged and/or claim damages.

⁵⁶ [1992] 2 AC 128.

⁵⁷ [2004] EWHC 127 (Comm)

The meaning of material breach triggering a right to terminate the contract was recently addressed in *Dalkia Utilities Services Plc v Celtech International Ltd*⁵⁸, in the context of contracts for the provision of electricity and steam for the operation of a paper mill. The Commercial Court held that it was common ground that “material” breach did not mean repudiatory breach. In assessing the materiality of any breach it was relevant to consider not only the breach but also the circumstances in which the breach arose, including any explanation as to why it had occurred. In this case, three instalments of charges were due and unpaid by the defendant. The sums involved were neither trivial nor minimal and the defendant’s continued failure to pay them was serious. The defendant did not fail to pay because of a mishap, mistake or misunderstanding, but because he did not have the money to do so, in circumstances where the picture presented to the claimant was that the defendant was facing insolvency, and where the claimant could not, in practice, realise the plant unless there was a termination. The Court concluded that the defendant was in material breach of his obligations.

⁵⁸ [2006] 1 Lloyd’s Rep. 599.