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Sales and Purchase Agreements (SPA) – Potential Issues

Direct and Indirect Loss

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In almost every corporate deal involving an acquisition, areas ripe for debate between buyers and sellers arise around the issue of limitation and exclusions of liability. Specifically, who is to bear the risk (and for this read "cost") of matters that might give rise to a breach of the parties' contract if they come to light after the deal is done?

Drilling down further, you then come across the terms "direct loss" and "indirect loss" and the perennial questions of what is the difference, and why might it matter for your deal?

Direct and Indirect Loss

When answering the above questions, the starting point is the case of *Hadley v Baxendale* that has been good law now for approaching two centuries.[1] This case defined the circumstances in which loss/damage may be recoverable for breach of contract as arising in one of the following two ways:

1. If the loss can fairly and reasonably be said to flow naturally ("according to the usual course of things") from the relevant breach (often called the "first limb" and "direct" loss).
2. If the loss is of a nature that at the time of the contract the parties knew, or can reasonably be supposed to have known, was likely to flow from a breach (the "second limb" and "indirect" loss).

Indirect loss (also called consequential loss, which is terminology that itself can give rise to some uncertainty) will arise from a special circumstance and is therefore not in the "usual course of things". Such loss will therefore only be recoverable if the buyer knew or should have known of that circumstance when it made the contract. Absent such knowledge or awareness, the indirect losses would be regarded as exceptional and so not recoverable irrespective of any limitation of liability provision in the contract.

On the other hand, direct loss covers those losses arising as a natural result of a breach. Most foreseeable kinds of loss will be direct. This will often, particularly in the context of a corporate transaction, include financial losses such as loss of profits and loss of business or goodwill. It is therefore not correct to equate indirect losses with loss of profit, or to group them together. The two are not the same and loss of profits will often not fall within indirect losses at all.

Foreseeability in a given matter will be the practical touchstone when determining if a loss is to be regarded as direct or indirect, recoverable or irrecoverable, rather than consideration of the nature or type or even description of the particular loss at hand. This therefore means most recoverable losses suffered will be direct losses, as they will be the usual, and predictable results of a relevant breach. In comparison, indirect losses are taken to be unusual and unexpected and will often be the result or consequence of a special circumstance.

The circumstances where indirect loss becomes recoverable is where there was awareness on the part of the party in breach, at the time of entering into the contract, of the relevant matters or circumstances which resulted in a particular, indirect loss arising. This awareness does not change the nature of the loss from indirect to direct; it remains categorised as an indirect loss, albeit now one recoverable under the "second limb" of *Hadley v Baxendale* noted above.

Potential Difficulties Presented by the Term "Consequential Loss"

As already noted, the conventional approach is to treat "consequential" and "indirect" as the same, and this position has been broadly reiterated by both the English High Court and Court of Appeal. However, this position has come under increasing criticism in recent decades as arguably such an interpretation, particularly of "consequential", flies in the face of how most businesspeople (and indeed lawyers) would sensibly interpret and understand this word. Given that the court's current approach to contract interpretation is presented as being based on what a reasonable businessperson would think the parties intended by it, this sets up a direct tension between the court's approach to interpretation, and on the other the grouping together of "indirect" and "consequential" losses.

It is noteworthy that in some cases judges have departed from the court's previous interpretation of such words, but this tends to be very case and contract specific. Such decisions have been rooted in a finding of what the parties had intended the relevant wording to mean in a given case, determined to be different from the usual meaning.

Notwithstanding, for now at least it can be assumed that the conventional approach as to the proper interpretation of "consequential" remains the law i.e. consequential loss = indirect loss.

1 *Hadley v Baxendale* (1854) 9 Ex 341 (23 February 1854)

So How Might I Best Approach These Issues?

Taking things back to first principles (i) it will be for the party seeking to rely upon an exclusion, or limitation of liability to prove that the relevant clause actually covers the disputed matter; and (ii) absent express words that clearly indicate a party has abandoned a legal right, the court will be slow to uphold any argument that it has been so abandoned. A great deal of time and money can be expended by parties litigating clauses which lack clarity and/or specificity; ambiguity is no-one's friend.

Consequently, the safest course when drafting or marking up someone else's proposed clause(s) seeking to limit or exclude certain liabilities, is simply to be very clear what specific types of loss it is being agreed will be covered. It also pays to be very careful how and where you use the broader language of direct and/or indirect/consequential, particularly when listing out specific types and categories of loss intended to be covered by a given clause. Additionally, where a clause seeks to exclude loss of profits, give careful thought to whether these losses are, in fact, the direct losses that are likely to flow from any breach of the relevant provisions. If so, excluding a right to recover lost profits risks eliminating the claiming party's ability to recover any of its losses.

If parties have agreed that they intend to exclude certain specified direct financial losses, as well as indirect loss, then they would be well-advised to draft these points as separate clauses, and to ensure that they state in respect of the financial losses that both direct and indirect financial losses are intended to be excluded. Any ambiguity around this point might lead a court in the future, when it came to construe any clause(s), to consider that only indirect losses were excluded as it would not make commercial sense to have agreed otherwise.

Not only should the taking of such care minimise future disputes over actual meaning and intention, but it also safeguards against any uncertainties should the court in the future amend its approach to the interpretation of indirect/consequential in the context of loss/damage claims.

We are always happy to consider and advise on exclusion or limitation of liability provisions during any negotiations. Please get in touch with your usual contact, Christian Toms or Kate Wakeham.

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