Introduction

Limitations and exclusions of liability are two of the most contentious and frequently discussed topics for those involved in negotiating and drafting commercial contracts.

This article attempts to set out some guidance on how to understand this complex area of law. It will hopefully be of use to both suppliers and their customers in helping to understand the law and the effects of particular drafting.

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When a party might be liable

Contract – a contracting party who fails to comply with the express or implied terms of a contract might be liable.

Negligence – that party may also be liable in negligence by failing to exercise the degree of skill and care reasonably expected in circumstances where a duty of care is owed to the other party (as will typically be the case with a contractual relationship).

Liability for negligence can exist independently of, and in parallel, to a contract.

Misrepresentation – a contracting party who has made a statement before the contract was finalised which turns out to be false could be liable if the other contracting party relied on that statement when it entered into the contract and it was reasonable for it to do so.

NO LIMITATIONS OR EXCLUSIONS

What is the position on liability when there are no limitations or exclusions in the contract?

Most contracts seek to limit or exclude a contracting party’s liability for breach of contract and negligence in one way or another.

However, in the absence of any limitation or exclusion, what would the position be?

First, it is necessary to look at:

- when a party might be liable;
- what the injured party has to prove to show that the other party was liable; and
- what damages can be claimed.

This Guide focuses on limitations and exclusions of liability under English law in the context of business to business transactions. It does not consider the law relating to consumer contracts, which differs in some key respects.
What does the injured party have to prove?

Assuming that a breach of contract, negligence or a misrepresentation can be proved, the injured party must then establish that:

- the breach, negligence or misrepresentation in question actually caused the damage suffered by the injured party; and
- the type of damage suffered passes the 'remoteness test'.

What damages can be claimed?

For breach of contract, an injured party may seek to recover:

- the benefit which it expected to receive had the contract been performed in accordance with its terms. This benefit can be assessed either on:
  - the basis of the difference in value between what was delivered and what should have been delivered; or
  - the cost of curing the breach; or
- wasted expenditure incurred in anticipation that the contract would be performed.

Traditionally, the injured party had to choose between these alternative bases but recently there has been some slight relaxation of that rule provided the Court is satisfied there will be no element of 'double recovery'.

For negligence, an injured party may try to claim damages to put it back into the position it was in before the negligence occurred.

For misrepresentation, in most cases an injured party may seek to recover damages on the same basis as for negligence.

The principal function of damages for breach of contract, negligence and misrepresentation is to compensate the injured party.

Some losses that are recoverable

Loss of profit will often be a direct loss and therefore can be claimed.

In principle, the cost of wasted management or staff time is recoverable as a type of damage that can be claimed if an injured party can establish that management or staff have been significantly diverted from their usual activities.

Losses that are not recoverable

The injured party cannot claim damages for any part of its loss which it could have avoided by taking reasonable steps. This is referred to as the 'duty to mitigate'.

Does the scale of damage matter? No, generally it is the type of loss which has to be foreseen or contemplated in order to be recoverable not the precise detail or the extent of the damage.

Once the type of loss is established as not being too remote, it should be possible to claim for all loss of that type, although recently some very senior judges have stated that this will not always be the case.

What is the 'remoteness test'?

In contract, the test of remoteness enables injured parties to recover:

- losses arising naturally from the breach in the normal course of events; and
- such losses as may reasonably be supposed to have been in both parties' contemplation when they made the contract, as a probable result of the breach.

For negligence, the test of remoteness is simply that the damage must be reasonably foreseeable (ie damage which a reasonable person could anticipate as the result of the negligence).

For misrepresentations, there are different tests for remoteness depending on whether the misrepresentation claimed was innocent, negligent or fraudulent.

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What is the duty to mitigate?

The duty to mitigate is not an onerous one but the injured party:

- must take reasonable steps to minimise its loss; and
- must not take unreasonable steps to increase the loss.

Where the injured party incurs expenses or suffers loss due to taking reasonable steps to mitigate, it can recover those expenses or losses.
Potential liability if there is no exclusion or limitation of liability

So assuming a defaulting party is liable and the other party can prove this, if there are no exclusions or limitations on the defaulting party’s liability in the contract, then the potential liability can be very significant.

In particular the compensation awarded:

- can be entirely unrelated to the value of the contract or the level of profit expected by the party in breach; and
- for the same breach may vary considerably according to the particular individual circumstances of the injured party.

It is therefore perhaps not too surprising that contracting parties look to limit or exclude their liability as a matter of routine.

There are three main points to consider here:

- incorporation;
- effectiveness; and
- legal restrictions.

Incorporation – is the exclusion or limitation validly incorporated into the contract?

An exclusion or limitation provision will be assumed to be incorporated if it is included within a signed, written agreement.

Otherwise, reasonable steps must be taken to bring the exclusion or limitation to the notice of the other party before the contract is made.

Generally, no particular special steps need to be taken to make sure that exclusion or limitation clauses are validly incorporated and the threshold for incorporating standard terms into a contract with a business customer is not particularly high.

Effectiveness - is the exclusion or limitation effective to cover the breach?

The party seeking to rely upon the exclusion or limitation must prove that it is effective in covering the breach in question. A liability clause, for example, must therefore specifically deal with all possible bases of liability such as:

- breach of contract;
- negligence;
- misrepresentation; and
- both acts and omissions.

Failure to refer to negligence explicitly would be a serious mistake because, for example, an exclusion or limitation in relation to ‘any loss’ may not be sufficient to cover losses resulting from negligence.

Legal restrictions - does the law impose any constraints on one party’s ability to exclude or limit its liability to the other?

The starting point under English law is that the parties are free to agree the terms of their contract between them. However, there are some legal constraints on this freedom - a contracting party cannot exclude or restrict liability at all for:

- fraud - exclusion or limitation clauses will not be effective if they exclude or limit liability for fraud or fraudulent misrepresentation as a matter of public policy.

This is why in one recent notable case, the injured party successfully managed to prove that the supplier’s salesman had been deliberately dishonest amounting to fraud. The result was that the supplier was not able to rely on its limitation of liability clause;

- death or personal injury caused by negligence;
- breach of the conditions implied by statute in sale of goods contracts that the seller has good title to the goods and that they are not subject to any form of impediment.

(The latter two bullet points are the result of the Unfair Contract Terms Act 1977 (“UCTA”).)

Most limitation clauses will make it clear that they are not attempting to exclude or restrict liability for such matters for fear that if any part of the exclusion or limitation clause goes too far, all of the provision may be held to be unenforceable.
Assuming UCTA applies and that the clause has been validly incorporated, covers the particular type of claim in question and is not prohibited by law, the next point to consider is whether the clause is enforceable under UCTA.

Liability that may be excluded or limited subject to the reasonableness test

Different rules apply under UCTA according to the type of liability being excluded and/or limited.

- negligence not resulting in death or personal injury;
- breach of the conditions implied by statute relating to description, satisfactory quality, fitness for purpose and corresponding with a sample;
- when dealing on a supplier’s standard terms of business - liability for breaches of contract or where the supplier claims to be entitled to provide a contractual performance substantially different from that which was reasonably expected or to provide no performance at all; and
- non-fraudulent misrepresentation.

Other restrictions

There are other restrictions that are also caught by UCTA, which may not appear to be limitations but which the Courts consider them to be:

- limiting the other party’s remedies;
- entire agreement provisions excluding pre-contract misrepresentations; and
- indemnities.

Limiting remedies

Anything which potentially operates to limit or restrict the remedies available to a customer may be subject to scrutiny under UCTA.

So, for example, any provision which requires claims to be notified to the supplier within a limited time frame will be regarded as a form of limitation and will therefore be subject to the reasonableness test. If the time frame for seeking a remedy is set too short without clear justification, such a provision may be unenforceable.
Excluding pre-contract misrepresentations

Liability for pre-contract misrepresentations is typically excluded through what is known as an ‘entire agreement’ clause.

If such a clause operates as an exclusion of liability for misrepresentation, it will be subject to the reasonableness test.

The principle behind entire agreement clauses is a sensible one, aimed at providing greater certainty for both parties.

However, the Courts have recently shown that entire agreement clauses will be subject to highly technical examination.

Mindful perhaps of fairness in individual cases, the Courts have found ways of interpreting the drafting of what seem to be straightforward, all-encompassing clauses as only having limited effect.

The fact is that even with the best drafting, sales people do need to be reminded of the obvious dangers of overselling and that entire agreement clauses may not always be effective in coming to the company’s aid to exclude liability for any misrepresentations made.

Indemnities

Indemnity provisions are not specifically regulated by UCTA but may in certain circumstances be held to be subject to it.

A term which requires an innocent party to indemnify the other party against claims arising from the default of that other party is treated as an exclusion clause and therefore is subject to UCTA on that basis.

The concept of ‘reasonableness’ is absolutely key in determining the enforceability of exclusion and liability clauses.

It is crucial to understand that reasonableness will be judged on a case by case basis and although wording in one contract may be upheld as being reasonable, that same wording may be declared unreasonable in another depending upon the circumstances.

Passing the test

- Fair and reasonable - a contract term must be "fair and reasonable ... having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made".
- Plain English - if the clause is clearly drafted and legibly presented (so that, for example, it is "understandable by any intelligent businessman"), there is a better prospect that a Court will be satisfied that the content is reasonable. Of course, the converse is also true.
- However, even with the best-drafted clause, there is no guarantee that the reasonableness test will be satisfied in every case.
- Obvious mistakes should be avoided to improve the chances of the clause being upheld.
Onus of proof

It is important to note that the onus of proving that an exclusion or limitation clause is reasonable is on the party relying on it, usually the supplier.

Factors to consider

UCTA sets out a non-exhaustive list of factors to be taken into account in assessing reasonableness. In summary they include:

- the relative bargaining strength of the parties;
- whether any particular inducement was given to the customer to agree the term in question;
- whether the customer had an opportunity of entering into a similar contract with other suppliers without having to accept a similar term; and
- whether the customer knew, or ought reasonably to have known, of the existence of the term (having regard, among other things, to any industry practice and any previous course of dealing between the parties).

Where a party seeks to limit liability to a specific financial sum, the Court must have particular regard to:

- the resources available to that party to meet the liability; and
- the extent to which that party could have covered itself by insurance. ⇨ inset box below

What happens if an exclusion or limitation is found to be unreasonable?

If an exclusion or limitation is found to be unreasonable the provision will generally not work to exclude or limit liability as intended and it will be completely unenforceable.

So, for example, a clause limiting liability to a specified financial sum will result in unlimited liability if the limit is set too low. The clause will not be re-written by the Courts. Therefore, a definite danger exists in trying to make an exclusion or limitation clause too restrictive.

Exclusions of liability for particular categories of loss which are found to be unreasonable and which appear in a list may be capable of being deleted on an individual basis by the Court using its so called 'blue pencil'.

Although the Courts seem to vary in their willingness to do this, the chances of this happening are improved somewhat if each exclusion is included within its own separate sub-clause.

Some background

Over time, the Courts have generally been more prepared to uphold financial limitation clauses than previously and recognise their legitimate commercial justification as a valid apportionment of risk.

Please note, however, that an argument to justify a particular limitation clause (however tempting and natural it may appear) along the lines that such a limitation is 'industry standard' may not automatically work.

Also, the Courts' decisions on what limit is reasonable have not been entirely consistent and unfortunately there is limited certainty that even if best practice is followed, clauses will necessarily be upheld. The nature and extent of the conduct being complained of seem to be influential factors.

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REWELLANCE OF INSURANCE

The existence of insurance is relevant to the reasonableness of the limit on liability stated in the contract but the fact that the level of cover exceeds the limit in question does not prevent the cap from being fair and reasonable under UCTA.

Where insurance cover is being relied upon, it is essential to check with insurers that the provisions of the contract (particularly standard terms but also unusually onerous limits or exclusions) will not invalidate the insurance cover.

Be careful not to mix a reference to an obligation to maintain insurance in with the limitation clause - in one case this rendered the limitation unreasonable as the Court misunderstood the nature of insurance and for whose benefit the insurance was being put in place. The Court also seemed to assume the customer was effectively paying the premium.
There has been a catalogue of cases examining liability clauses over the last 20 years or so.

Initially, cases focussed on clauses which were very restrictive and which limited damages to a small fraction of the contract value or price paid. Not surprisingly, the Courts had no real problem in declaring them to be unreasonable.

However, it then became clear that some judges also disliked more generous financial caps and regarded suppliers as being better placed to cover the risk than customers.

The focus was on whether the damage which might be suffered due to the breach was likely to exceed the limit and the resources available to the suppliers.

**Views on different types of limits**

The Courts’ views on different types of limits or ‘caps’ in various cases have been mixed:

- **price paid:**
  - where the limitation was set at ‘100% of the price paid’, this was seen as a very low ceiling and it was held to be unreasonable;
  - in contrast, a ‘price paid’ limitation was upheld, recognising that the project in question involved considerable risks, that both parties were, or ought reasonably to have been, aware of the risks at the time of the contract and that the customer was in the best position to assess the likely loss.
  
  It was said that although the risk could be covered by insurance, this would come at a cost and that both parties knew, or ought reasonably to have known, that the identity of the party who was to bear the risk of loss would be a factor in determining price;
  
  - where the supplier could refuse to perform the contract and would only be liable to refund instalments of the price paid, this would be unlikely to appeal to a purchaser and would raise the issue as to whether it can have been the parties’ intention for the contract to be so unbalanced - likely to be challengeable under UCTA (although not directly addressed);

- **multiple of price paid** - because of the particular context, a cap equivalent to ‘four times the price paid’ was declared unreasonable;

- **refund/repair or replace:**
  - a complete exclusion of any liability other than to refund the price paid or repair or replace was held to be unreasonable, "being too wide an exclusion clause";
  
  However, in another case a remedy limited to ‘repair or replacement’ was later held to be reasonable by implying a limit to the scope of the exclusion. The Court said that if the defect could not be put right there would be a serious ‘repudiatory’ breach and, "it is hard to see how … the exclusion of losses … could [have been intended to] apply to such a fundamental breach".

**Current view**

Since these cases, the Courts have mostly viewed financial limitation clauses with less suspicion. As one judge said, "limiting liability to the contract price was not regarded as being particularly unusual or onerous”.

Another commented, “having regard to the enormous potential liabilities, the [money back guarantee] seems to me to be a reasonable arrangement in the circumstances”.

**Drafting points**

Regarding drafting limitation clauses, contracting parties should note:

- generally, the higher the limit the more likely it is to be held to be enforceable;

- regarding limits defined with reference to the contract value or price paid:
  - these are fairly typical, although price paid limitations seem to be very much on the borderline of enforceability;
  
  there will often be a significant difference between the price paid and the value of the contract at any given point so any limitation clause should be considered carefully to see exactly what the drafting is referring to;
  
  when little or nothing has been paid, it might be worth including an alternative minimum limit to the price paid to cover the initial period, to reduce the chance of the clause being declared unreasonable
(particularly where there is significant initial development work, a period typically considered to be high risk in implementation projects);

◊ in a long-term contract, liability will often be set with reference to sums paid in the preceding 12 months. Care needs to be taken to clarify when that 12 month period is measured from and to include a minimum as an alternative when little or nothing has been paid (see above);

◊ in recent years there has been a general move for limits to be set at a multiple of the price paid or contract value (anything between 110% and 150%);

- a limit defined with reference to sums ‘payable’ is not the same as the contract value and has an inherent uncertainty. If used, this term should be clearly defined;

- it may be useful to be able to demonstrate that:
  - any limitation has been the subject of due thought and analysis with notes to support this, particularly any investigation of insurance and its impact instead of having been set by just picking a figure ‘out of a hat’ or simply following industry practice;
  - a customer was presented with the option of a higher limitation in return for it being prepared to pay a higher price, perhaps the cost of any additional insurance premium.
  (Although query to what extent insurers are prepared to increase the level of cover on an individual contract by contract basis?);

- it is generally unwise to set limits ‘per event or series of connected events’ because of the ambiguity regarding what constitutes an individual ‘event’ or whether events are ‘connected’. Doing so could multiply the potential liability enormously.

'Consequential' loss

This is a very misunderstood term and it is important to note that ‘consequential’ loss has been defined by judges as loss which is not direct.

Hence, it effectively only excludes liability for indirect loss and it certainly does not have its ordinary anticipated meaning of loss as a consequence of a breach. An exclusion of liability for consequential loss therefore excludes relatively little, if anything.

By way of example, an exclusion of liability for ‘indirect or consequential losses’ in one case was held not to exclude liability for:

- extra charges incurred by a business to suppliers due to problems with an IT system which made calculating what was actually due impossible;
- compensation paid to customers;
- additional borrowing charges;
- costs of wrongly chasing customers; or
- additional stationery costs.

Loss of profit

As mentioned above, this is often a form of direct loss. A party wishing to exclude liability for loss of profit should do so explicitly as a standalone exclusion and certainly not as a sub-category of consequential or indirect loss. Where excluded as a sub-category in this way, only indirectly arising loss of profit will be excluded leaving the party liable for any loss of profit which is incurred directly.

Careful consideration required

The types of loss that may arise should be considered very carefully and wording to specify which losses are to be excluded should be as clear as possible. Always ensure the customer has the option of a substantive remedy.

Traditional terminology may be of limited value - either because it is too vague or uncertain or because it will be regarded as being too broad and all-encompassing in scope. Either way, the clearer and more precise the wording used, the better.
Liquidated damages

'Liquidated damages' (sometimes called 'service credits' or 'rebates' in services contracts) are another way of limiting liability (provided they are stated to be an exclusive remedy).

They operate by way of a pre-agreed obligation to make certain payments which are triggered by a particular, identified breach of contract.

Liquidated damages are recoverable provided they do not constitute a penalty.

Provisions may or may not be described as 'penalties' but that does not determine their legal status - the terminology used is not relevant. The Courts will look to see whether the provision was in fact a penalty or not.

What constitutes a penalty?

The previous test of a 'genuine pre-estimate of loss' has been replaced with looking at whether the disputed provision results in the defaulting party suffering a detriment which is disproportionate to the injured party's legitimate interest.

Even if the amount set out does not strictly relate to the loss incurred due to the breach, it will not necessarily be a penalty if the innocent party can show that there is a justified reason why compensation for the actual loss suffered would be insufficient.

Also, compensation may not necessarily be the only legitimate interest that the innocent party may have with respect to the performance of a defaulting party's primary obligations.

In commercial contracts, particularly those between 'substantial and experienced' companies, the Courts exercise very great caution before striking down a clause as a penalty.

If it is clear that the primary purpose of the provision was to act as a deterrent against breach rather than being truly compensatory in nature, then the Court may be prepared to declare the clause a penalty.

However, this is now relatively rare.

Can liability for extremely serious breaches be excluded or limited?

Yes - there is no general principle of law that prevents a party from excluding or limiting its liability for extremely serious breaches.

Clauses properly drafted are perfectly capable of applying to cases of such 'fundamental breach'.

Can liability for gross negligence be excluded or limited?

Yes - English law does not prohibit excluding or limiting liability for 'gross negligence' as is the case in some jurisdictions (such as in continental Europe) but there is some doubt as to whether English law recognises 'gross' negligence as a separate category of negligence.

However, it now seems that the Courts will give effect to drafting which attempts to draw a distinction between 'ordinary' and 'gross' negligence.

Nevertheless, given that there is some uncertainty surrounding use of this term, rather than referring to it, it is better to be specific in the contract about the type of conduct which the parties do not intend to be covered by the limitation or exclusion.

Can an exclusion or restriction of liability be effective to cover deliberate breaches?

Possibly. One case suggested that there is a presumption that an exclusion or limitation clause will not apply to intentional or deliberate breaches unless there is very clear wording to show that this was the parties' intention.

However, a later decision challenged this which, if followed, would reverse this position. The Court of Appeal admitted that there is a conflict between these different rulings and has granted permission for an appeal to be heard in the hope that the contradiction can be resolved.

However, no appeal has been reported at the time of writing.

Therefore, a party who wants to specify that the other party's liability is not limited if it commits a deliberate breach of contract, should amend the agreement to say so.

Although there is no certainty currently on the effectiveness of this, the Courts will always strain to interpret an exclusion clause against a party in breach, and probably more so in the case of a party guilty of deliberate repudiatory breach.
Legal fees in disputes

The party that wins a dispute is generally awarded a significant proportion of its own legal costs in addition to any damages that are awarded. However, any award is never going to cover all of the costs incurred.

The losing party obviously has to bear its own legal costs in addition to any damages it has to pay out to the other party. Legal costs are therefore a very significant potential liability to be born in mind as and when any dispute arises.

Somewhat strangely, clauses which limit liability rarely, if ever, make it clear whether the limit includes any liability for legal fees. Perhaps they should?

A generous limitation and exclusion clause can be a positive selling point, emphasising confidence in the applicable product or service and speeding up negotiations, thereby saving both time and money and ensuring that the relationship gets off on a constructive note.

That having been said, well-drafted limitation and exclusion clauses do have an appropriate place in a company’s risk management strategy and in suitably apportioning risk between contracting parties. The drafting of such clauses clearly needs to take full account of the law and how the Courts may interpret these provisions should they be tested.

Customers too need to recognise that certain limitation and exclusion clauses are perfectly legitimate and allow them to receive the benefit of goods and services at significantly lower prices than might be the case if suppliers had to factor in entirely open-ended liability.

Such clauses also help to emphasise to customers that they are well-advised to manage their risks in other ways and not just rely upon the supplier bailing them out should things go wrong. Limitation and exclusion clauses are all about getting the balance right.

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