1. Introduction

Proper risk allocation in contracts has become much more topical in recent years. This is hardly surprising given the increasing complexity of transactions in commerce and the potential liability which can attach to breaches of contract, negligence and other unlawful conduct.

In order to achieve proper risk allocation it is necessary to identify the risks and then properly allocate them.

In allocating them, it is important to ensure that the risk allocation is properly dealt with in the relevant contracts. This will often necessitate the use of, among other things, warranties, exclusions and limitation of liability clauses and indemnities.

These types of clauses are often very difficult to draft to properly reflect the agreed risk allocation and more often than not are not properly thought through except by highly experienced lawyers.

In order to draft warranties, exclusions and limitation of liability clauses and indemnity clauses which properly allocate risk it is necessary to fully understand:

- the purpose of each of these type of clauses;
- the limitations on their enforceability;
- what might be obtainable in the market place;
- the potential pitfalls in relation to their drafting.

Each of these issues is discussed below.

2. Warranties

2.1 What are they?

The term “warranty” is used interchangeably:

- as a category of terms of contract;
- as a statement as to a state of affairs;
- as a statement of a required level of performance of an asset, piece of equipment, service, etc;
- to describe a term to be implied by statute.
Warranties v Conditions

Under Australian law, warranties are terms which are less important or fundamental than conditions of contract. A breach of a warranty will not of itself entitle a party to terminate or, more properly, accept repudiation of the contract and recover damages. It will only entitle the innocent party to recover damages.

Whether a term is considered a condition or warranty is dependent on the test of essentiality which was expressed in *Tramways Advertising Pty Ltd v Luna Park (N.S.W) Ltd* (1938) (SR) (NSW) 632 as follows:

"the test of essentiality is whether it appears from the general nature of the contract considered as a whole, or from some particular term or terms, that the promise is of such importance to the promisee that he would not have entered into the contract unless he had been assured of a strict or substantial performance of the promise, as the case may be, and this ought to have been apparent to the promisor."¹

Conditions of a contract are major or fundamental terms, the breach of which "goes to the heart of the matter, so that a failure to perform it would render the performance of the rest of the contract a thing different in substance from what [is] stipulated for."² A breach of a condition will entitle the innocent party to terminate the contract if it chooses and recover damages, or in some cases quantum meruit.

Warranties are minor contractual terms. They are such that the parties did not intend that a breach of them would substantially affect the performance of the obligations under the contract and entitle the innocent party to terminate. However, the innocent party will be entitled to damages to compensate it for the breach.

The courts have also recognised that it is not always easy to differentiate between conditions or warranties and, as a result, the courts have recognised a third class of contractual terms: innominate or intermediate terms. Intermediate terms are neither conditions nor warranties but are capable of both minor and major breaches. As for a condition, a major breach will entitle the innocent party to terminate and pursue an action for damages or affirm the contract and recover damages. As for a warranty, a minor breach will only entitle the innocent party to seek damages.

In *Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd* [1962] QB 26, the plaintiffs had chartered a ship from the defendants which was to be fit for ordinary cargo service. Due to the age of the machinery and the incompetency of staff, 20 weeks of sailing were lost as a result of engine trouble and the plaintiffs rescinded the charter, suing for damages and breach of contract.

The court held that while the defendants were in breach of their obligations, seaworthiness was not a condition of the contract and did not entitle the plaintiffs to rescind. It held that the breakdown and delays suffered did not defeat the main purpose of the contract and stated that when classifying a term, the court should consider the events which occurred as a result of the breach at the time of the purported rescission of the contract and decide

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¹ *Tramways Advertising Pty Ltd v Luna Park (N.S.W) Ltd* (1938) (SR) (NSW) 632 at 641-642 per Jordan CJ

² *Bettini v Gye* (1876) 1 QBD 183 at 188 per Blackburn J
whether the occurrence of those events would deprive the party of substantially the whole benefit of the contract as intended by the parties.

**Warranties being representations**

Another form of warranty is a statement or acknowledgment in a contract asserting certain facts or representations. For example, parties to a contract may warrant the accuracy of information provided in pre-contractual negotiations or documents that comprise part of the contract or may warrant that they have capacity to enter into a contract. The contract, if well drafted, will set out the rights available to the innocent party if the warranties are untrue.

**Warranties as to performance**

Performance warranties assert a level of performance under a contract. They may be provided by a contracting party supplying a particular good or service to another which prescribes a certain standard that the good or service to be supplied must maintain or be capable of satisfying.

**Statutory Warranties**

Statutory warranties are found in consumer legislation such as the Trade Practices Act 1974 (Cth) (**TPA**). For example section 69 of the TPA implies the following warranties into a contract for supply of goods:

- That the supplier can pass to the consumer title in the goods;
- That the consumer will enjoy the goods without interruption; and
- The goods are free from any charge or encumbrance that is not made known to the consumer.

### 2.2 Enforceability of warranties

As warranties comprise part of the contract, and assuming the contract is enforceable, they are (in the absence of uncertainty, some form of statutory prohibition or public policy considerations) enforceable giving rise to remedies in the hands of the innocent party.

Depending on the nature of the warranty they might give rise to:

- A claim for damages (including liquidated damages);
- An express right of termination and a claim for damages;
- Statutory rights (which will often include a right to damages).

In order to be successful in an action for damages, the onus will be on the party alleging the breach to establish a sufficient connection between the breach and the loss suffered. Causation can be established in one of two ways:

1. if it can be proved that, but for the other party's breach, the alleging party would not have suffered the loss or damage; or
2. the other party’s breach is so connected with the alleging party’s loss or damage that, “as a matter of ordinary common sense and experience it should be regarded as the cause of it.”

Even if a causal link is established, a loss resulting from the breach may not be compensable if it is too remote. The alleging party must be able to satisfy the test for remoteness as set out in Hadley v Baxendale (1854) 9 Ex 341.

The two limb test in Hadley v Baxendale provides that damage will not be too remote if it may be reasonably considered:

1. as arising naturally according to the usual course of things from the breach (the first limb); or

2. to have been reasonably in the contemplation of the parties at the time they made the contract as a probable result of it (the second limb).

While there has been much debate as to the loss that will be considered to flow from the usual course of things as required under the first limb, Australian authority suggests that the test to be applied under the first limb is what loss is “sufficiently likely to result”.

In determining whether the loss or damage was reasonably in the contemplation of the parties under the second limb, regard must be had to the actual knowledge possessed by the defendant. In addition to actual knowledge of the circumstances, it is also necessary for either:

(a) the defendant to acquire this knowledge from the plaintiff prior to entering into the contract; or

(b) for the plaintiff to know the defendant has this knowledge at the time the contract is entered into.

2.3 Points to consider when drafting

There may be many specific points to consider when drafting warranties and these will depend on the type of warranty you are drafting.

Irrespective of the type of warranty you are drafting, the two most important general issues are:

• certainty;

• specifying the consequences which will flow from the warranty not being met or observed.

The most important issue is to clearly draft the warranty so that it is certain and will not be ruled void for uncertainty. Too often warranties and representations and performance type warranties are drafted by non-lawyers using technical or quasi technical terminology and

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3 March v E & M H Stramare Pty Ltd (1991) 171 CLR 506 at 522

4 Burns v MAN Automotive (Aust) Pty Ltd (1986) 161 CLR 653 at 667 per Wilson, Dawson and Deane JJ citing Lord Reid in Koufous v C Czamikow Ltd [1969] 1 AC 350

5 Victoria Laundry (Windsor) Ltd v Newman Industries Ltd [1949] 2 KB 528
although the originator of the drafting thinks the terminology is clear and certain it is in fact the contrary. Lawyers who are finalising such clauses should ensure they are clear and certain and if they contain technical terms should ensure that those terms are either well known and understood or are clearly defined.

Secondly, it is important to set out in the contract the consequences which will flow from a breach of the warranty. In other words, it is essential to make it clear whether it is a warranty as opposed to an intermediate/innominate term or a condition. This is best achieved by making the termination provision in the contract a code for termination and clearly identifying which breaches of which warranties will allow the innocent party to terminate and recover damages. However, as a breach of warranty usually results in a right to damages, it would be unusual for a breach of warranty to give rise to a right of termination and such suggestion may be met with opposition from the other party. Equally it is worth considering whether a liquidated damages regime will apply to a breach of the warranty prior to or following termination. It should be kept in mind that, unless a contract clearly specifies otherwise, a liquidated damages regime will not apply following termination.

Issues relating to liquidated damages regimes are discussed further below. One particular issue which arises in relation to liquidated damages regimes tied to performance warranties is whether the liquidated damages regime will apply so as to amount to a limitation of liability for all breaches which relate in any way to or contribute to the breach of the relevant warranty. For example, some equipment supply contracts (eg power station contracts) will set out obligations regarding compliance with designs, quality of work, times for completion, etc. They will also then stipulate performance warranties in relation to the performance of the power station as regards electrical output, heat, etc. They will then go one step further and provide for liquidated damages to be payable if the relevant performance warranties are not met. For example, they will provide for so many dollars per unit of electrical output not achieved. The question arises whether, without more in the way of drafting, a breach of the obligation to comply with the design leaves the innocent party with only a right to recover the liquidated damages which flow from the failure to achieve the performance warranties. This uncertainty can be overcome by clear words in the contract stating whether or not this is the effect.

2.4 What to ask for and what to accept

What the parties should ask for and what they will be able to achieve in terms of warranties will very much depend on the nature of the transaction, the bargaining position of the parties and the commercial overlay (including the insurance regime relating to the relevant contract or project).

In recent times the following approaches have been adopted in some major projects/contracts:

- Parties have been prepared to provide warranties regarding the accuracy of critical information, particularly where the other party has not had sufficient time or did not have the ability to satisfy itself regarding the accuracy of the information. More recently parties have focused on what is
really being relied upon rather than providing more general warranties as to accuracy.

- Parties have agreed to performance warranties in respect of critical performance measures in relation to equipment, plant and buildings, and specified liquidated damages regimes applicable to breaches of or failure to achieve those warranties. The parties have also very clearly specified in the contracts that the payment of those liquidated damages do not affect the innocent party’s rights to claim for damages for breaches of other clauses or terms of the relevant contract.

- The parties have agreed that the termination provisions will be a code for termination (meaning that the parties are not entitled to terminate at common law even if the relevant triggers in the contract for termination have not been met) and have specified which breaches of which terms will give rise to a right to terminate. They have also provided for a show cause procedure in respect of all other clauses which, if not satisfied, will give rise to a right to terminate. Where this approach is taken, the termination clause usually provides generous cure rights or remedy rights prior to the right to terminate arising and in respect of the show cause procedure gives the defaulting party an opportunity to show reasonable cause as to why the contract should not be terminated.

3. **Liquidated Damages**

3.1 **What are they?**

Liquidated damages are damages that are fixed (ie predetermined) by the parties to the contract to be payable in the event of a breach of contract.

3.2 **Enforcement of Liquidated Damages clauses**

For a liquidated damages clause in a contract to be enforceable, the clause must be certain and the liquidated damages specified must be a genuine pre-estimate of the loss that is expected to occur in the event of breach.

Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*\(^6\) set out the factors for consideration in determining whether a liquidated damages clause is a genuine pre-estimate of damage or constitutes a penalty. These principles are also applicable in Australia as a result of *O'Dea v Allstates Leasing System (W.A.) Pty Limited*\(^7\) which approved the judgment of Lord Dunedin.

As a result, the following factors must be considered when determining the enforceability of a liquidated damages clause:

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\(^6\) [1915] AC 79

\(^7\) (1983) 152 CLR 359
(a) if the liquidated damages sum is extravagant and unconscionable in comparison with the greatest loss that could conceivably flow from the breach, the liquidated damages sum will be considered a penalty;

(b) if the breach is non-payment of money and the liquidated damages sum is greater than the sum that ought to have been paid under the contract, the liquidated damages sum will be considered a penalty;

(c) where the liquidated damages sum is a single sum payable in respect of the occurrence of one or a number of events, there is a presumption that the liquidated damages sum is a penalty;

(d) where the consequences of a breach are such that a pre-estimate of the damage is impossible, the liquidated damages sum will be considered a penalty.

A liquidated damages clause specifying a minimum or maximum range was struck down in Arnhold & Co Limited v Attorney General of Hong Kong (1989) 47 BLR 129 as it was considered void due to uncertainty and considered a penalty (despite express wording in the clause to the contrary) as the maximum amount prescribed exceeded a genuine pre-estimate.

Another example of a penalty is to be found in the decision of In re Newman\(^8\), where the contract contained a set amount payable for a specific breach and a different amount payable for any breach.

In Philips Hong Kong Ltd v The Attorney General of Hong Kong (1991) Con LJ 340 (HK CA) the court stated that a liquidated damages clause would not be construed as a penalty merely because situations could be hypothesised whereby the liquidated damages would be greater than what could have been recovered as general damages.

It should be kept in mind that the courts have upheld liquidated damages clauses which seek to include holding costs.\(^9\)

It is also important to avoid the application of the "prevention principle"\(^10\) which might result in liquidated damages not being enforceable from the date of an act or omission of the innocent party which prevents performance of the relevant obligation by the defaulting party.

### 3.3 Points to consider when drafting

Liquidated damages will, provided they are enforceable, add a high degree of certainty to the rights and obligations of the parties and obviate the need to incur significant time and cost in proving on the one hand and defending on the other the quantum of damages following breach of a particular clause.

There are not too many issues to consider when drafting liquidated damages clause. The main issues are:

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\(^8\) [1876] 4 ER 724

\(^9\) See Multiplex Constructions Pty Ltd v Abgarus Pty Ltd & Anor (1992) 33 NSWLR 504

\(^10\) See Peak Constructions (Liverpool) Limited v McKinney Foundations (1970) 1 BLR 111
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- Ensure that liquidated damages are a genuine pre-estimate of the likely loss.
- Ensure that the clause is certain and the liquidated damages can be calculated (do not use ranges or formulae which do not work).
- As discussed earlier, clearly specify what breaches of what clauses the liquidated damages regime applies to so that it is clear what rights are preserved and not affected by the liquidated damages regime.
- Set out the machinery for the payment of or recovery of the liquidated damages including the timing of the payment, notices to be given, rights of set off, etc.
- Where there are a number of liquidated damages clauses, ensure that the clauses will not be struck down as a penalty because more than one of the liquidated damages clauses will apply to any one breach.
- In order to avoid the application of the "prevention principle" by allowing for any acts of prevention of the innocent party to be capable of being dealt with or oust the principle.
- As discussed earlier the liquidated damages regimes will not apply following termination of a contract, unless the contract clearly provides otherwise. If the intention of the parties is that the liquidated damages regime continue then that should be made abundantly clear in the drafting.

3.4 What to ask for and what to accept

In recent times parties have been more and more prepared to accept liquidated damages regimes so as to avoid the time and cost involved in claiming or defending claims for damages arising from breaches where a genuine pre-estimate is possible. Having established the amount as a genuine pre-estimate, the only real issue is whether the liquidated damages should be capped or not.

4. Exclusion of Liability Clauses and Limitation of Liability Clauses

4.1 What are they?

Exclusion of liability clauses and limitation of liability clauses seek to exclude, reduce, limit or otherwise qualify the rights or obligations of a party under a contract.

Exclusion of liability clauses operate to exclude the rights a party would otherwise possess under a contract or at law for default or other unlawful acts or omissions of the other party.

Limitation of liability clauses operate to qualify in some way the rights of the innocent party. This may be done by:

- limiting a duty or obligation which would otherwise be owed to the other party;
- limiting a party’s liability as to time;
- limiting a party’s liability by reference to types of damages or losses; or
• limiting a party's liability to a set amount.

An example of a clause totally excluding liability, as contained in a construction contract recently entered into provides:

The liability of each party is limited as provided in Item [*].

The limitation of liability does not apply to –

(a) liability to provide security;
(b) liability to pay interest;
(c) liability out of which by law the party liable cannot contract;
(d) liability for infringement of any intellectual property rights;
(e) liability to pay the contract sum, and the value of variations;
(f) liability to pay any GST in accordance with clause 11B or otherwise;
(g) liability for fraud or malicious or deliberate criminal acts or omissions;
(h) liability for wilful default of the Contract;
(i) liability of the Contractor to the extent the Contractor is entitled to claim indemnity in respect of such liability under the Project Specific PI Policy, subject to the relevant indemnity being paid in accordance with the policy;
(j) liability of the Contractor to the extent that the Contractor would have been entitled to claim indemnity in respect of such liability under the Project Specific PI Policy, but for Exclusion 2 in that policy;
(k) any other liability specifically excluded by the Contract from the effect of this clause, and amounts payable in respect thereof shall not be included in the limit.

Except as provided in the preceding paragraph, the limitation of liability –

(l) applies to all liability whatsoever arising under or out of or in the course of the Contract or the performance thereof or in any way related thereto;
(m) includes but is not limited to negligence, misrepresentation or other tort of a party, or the servants or agents of a party;
(n) includes but is not limited to damages for breach of contract or arising out of repudiation, rescission or termination of the Contract;
(o) applies irrespective of the nature of the cause of action including but not limited to breach of contract, tort, quasi-contract, breach of a statutory duty and statutory liability.

The provisions of this clause continue to apply notwithstanding –

(p) fundamental breach;
(q) breach of a fundamental term;
(r) rescission, repudiation or termination for any reason; or
(s) frustration;

whether deliberate, unintentional or by operation of law.

Clauses excluding or limiting duties or obligations are often contained in contracts for the supply of equipment or services in situations where a party wishes to make it clear, for
example, that it is not responsible for design or that it does not give any warranty or promises relating to fitness for purpose.

Often parties will limit their liability in a temporal sense and provide that they will not be liable for any claims made or brought after a certain period of time. Great care needs to be taken to clearly specify whether the time limit relates to the time by when a claim must be made or whether it extinguishes all claims. Use of imprecise words could lead to the courts interpreting the clause to mean that no further services are required after the relevant period as opposed to meaning that it prescribes a limitation period for claims.\footnote{Pullen and Anor v Gutteridge Haskin & Davey Pty Ltd [1993] 1 VR 27}

Finally contracts may contain an overall cap or caps on liability. A typical clause might be worded as follows:

(a)\footnote{Pullen and Anor v Gutteridge Haskin & Davey Pty Ltd [1993] 1 VR 27} Notwithstanding any other provision of this Contract (other than paragraphs (b) and (c) below) and except to the extent that liability cannot be limited or excluded, the Contractor’s total ability for all events giving rise to liability on its part arising out of or in connection with this Contract, whether arising in contract, tort (including negligence), indemnity, strict liability, breach of warranty or pursuant to statute (other than liability in respect of claim by the Principal relating to a Performance Incentive Payment expressly payable under the Contract) shall be limited to 120% of the Contract Sum in aggregate.

(b) In no event shall either party have any liability whatsoever to the other party for loss of use, production, profit, revenue, business, data, contract or anticipated saving, or for delay, or for any financing costs or increase in operating costs or any economic loss for any special, indirect or consequential loss or damage except to the extent of:

(i) claims for damages payable by the Principal to the Contractor as a result of termination for breach, subject to the Principal’s total aggregate liability in respect of such claims not exceeding the amount which would have been payable had the Contract been terminated by the Principal for its convenience under Clause [*]

(ii) payments becoming payable upon termination for convenience by the Principal in accordance with Clause [*]; or

(iii) claims by either party of a Performance Incentive Payment expressly payable under the Contract.

(c) Notwithstanding paragraph (a), but subject to paragraph (b) above, the limitations on liability of the Contractor in paragraph (a) do not apply in relation to:

(i) claims arising from or in connection with loss of or damage to any property (including without limitation property of the Principal or third parties) subject to the Contractor’s totally liability not exceeding $20 million in the aggregate;

(ii) obligations relating to or arising out of or in connection with personal injury or death; and

(iii) any claim arising from or in connection with any Wilful Default or fraud by the Contractor.
For the purposes of the Clause ["], the term "Contractor" shall mean the Contractor, its affiliates, subcontractors and suppliers of any tier, and their respective agents and employees, whether individually or collectively.

4.2 Enforceability of exclusion of liability clauses and limitation of liability clauses

Generally exclusion of liability clauses will be valid and enforceable provided:

- the clause is clearly drafted and not uncertain;
- the clause has been incorporated into the contract: Oceanic Sun Line Special Shipping Company v Fay (1988) 165 CLR 197;
- the clause applies to the type of liability in question eg negligence; and
- no statutory provision applies to render the exclusion clause void.

The approach of Australian courts to the interpretation of exclusion clauses is highlighted in Darlington Futures Ltd v Delco Australia Pty Ltd [1986] 161 CLR 500 (Darlington).

In this case, a contract was entered into between Darlington (a commodities broker) and Delco authorising Darlington to engage in a form of commodities trading known as "tax straddles" on behalf of Delco. The contract contained a clause providing that "the Client…acknowledges that the Agent will not be responsible for any loss arising in any way out of any trading activity undertaken on behalf of the Client whether pursuant to this Agreement or not." Delco commenced proceedings for the recovery of losses suffered.

In examining Australian decisions in the area, the court noted that past decisions authoritatively stated the approach to be adopted in Australia to the construction of exclusion and limitation clauses by stating the following rule for the interpretation for both exclusion and limitation of liability clauses, which is consistent with the general approach to the interpretation of contracts:

"…an exclusion clause is to be determined by construing the clause according to its natural and ordinary meaning, read in the light of the contract as a whole, thereby giving due weight to the context in which the clause appears including the nature and object of the contract, and, where appropriate, construing the clause contra proferentem in the case of ambiguity."12

The court held that the clause related only to authorised transactions.

This approach was affirmed by the High Court in Nissho Iwai Australia Ltd v Malaysian International Shipping Corp, Berhad (1989) 167 CLR 219 and has been applied in numerous cases since.

The court in Davis v Pearce Parking Station (1954) 91 CLR 642 held that an exclusion clause could exclude liability for negligence provided the clause was clear, express and unambiguous in its terms.

In the event that an exclusion clause is ambiguous, courts will take the contra proferentum approach to its interpretation, and construe it strictly against the party seeking reliance on it (Photo Productions Ltd v Securicor Transport Ltd [1980] 2 WLR 283).

12 Darlington Futures Ltd v Delco Australia Pty Ltd [1986] 161 CLR 500 at 510
If an ambiguous clause has two potential meanings – one which protects the party seeking reliance on the clause and the other which does not – the court will read the clause down and construe the clause as not affording the party relying on it any protection (Lamson Paragon Limited v Spices Limited (1953) SASR 297).

The courts will avoid interpreting an ambiguous clause in a manner that may lead to an unjust or irrational result (Carlingford Australia v EZ Industries Limited (1988) VR 349).

In this regard terminology is important. Such clauses often use the words “consequential” and “indirect”.

In GEC Alsthom Australia Ltd v City of Sunshine (Federal Court, Ryan J, 20 February 1996, unreported) GEC brought a breach of contract claim against the City of Sunshine who were contracted to provide a certain level of gas energy flow. The level actually supplied was well below the amount expected. GEC argued that it had an objective expectation of the expected revenue and as a result of the breach, it had been deprived of this revenue. The measure of damages was said to be an amount representing that loss of revenue. The indemnity provided by City of Sunshine under the contract was for direct loss and specifically excluded consequential loss. GEC argued that this indemnity for direct loss was intended to cover all loss which would flow directly from the breach, including anticipated revenue.

Ryan J accepted GEC’s argument and found that the indemnity clause, in its context, was sufficient to provide GEC with an indemnity for damage flowing directly from the breach, including any loss of anticipated profits. His Honour did not regard loss of revenue as ‘consequential loss’ but defined this term as connoting "a loss at a step removed from the transaction and its immediate effects.”

Courts have been reluctant to provide a clear definition of indirect or consequential loss. Whether loss is considered to be indirect or consequential will be determined on the facts of each case. However, that is not to say that the courts will not adopt a consistent approach in interpreting these clauses. Waller LJ in British Sugar PLC v NEI Power Projects Ltd (1997) 87 BLR 42 stated that "once a phrase has been authoritatively construed by a court in a very similar context to that which exists in a case in point, it seems to me that a reasonable businessman must more naturally be taken to be having the intention that the phrase should bear the same meaning as construed in the case in point. It would again take very clear words to allow a court to construe the phrase differently."

In Deepak Fertilisers & Petrochemicals Ltd v Davy McKee (London) Ltd (1999) 1 All ER (Comm) 69 a methanol plant had been negligently built and production was lost while rebuilding took place. The court found that losses that had begun to clock up at once (eg cost of idle men and plant) were to be regarded as direct and not consequential.

In Pegler Ltd v Wang (UK) Ltd 25/02/2000 QBD Unreported it was held that the words "indirect, special or consequential loss" did not cover all loss of profits but only those profits lost which were indirect, special or consequential loss in character.
In *Hotel Services Ltd v Hilton International Hotels (UK) Ltd [2000] BCL 235* the Court of Appeal held that loss of profits in that case were a direct or natural consequence of the relevant breach.

Australian cases have considered the meaning of losses in the context of the two limb test of *Hadley v Baxendale*.

In *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd [2003] FCA 50*, GEC had repudiated software development contracts it had entered into with BHPIT. BHPIT was required to use its own resources to meet its obligations to its customer and claimed against GEC for loss of profit. The court held that the loss of profit claim was an indirect and consequential loss which fell under the second limb of *Hadley v Baxendale*.

In *Hungerfords v Walker (1989) 171 CLR 125*, Hungerfords had overpaid tax over a number of years in accordance with advice received from external accountants. Hungerfords claimed damages for the added cost of funding the business with borrowed money as a result of the loss of the use of money overpaid in tax. The court held that this loss was a foreseeable result of the overpayment of tax and, as a result, was within the contemplation of the parties and fell into the second limb of *Hadley v Baxendale*.

It is conceivable that some economic losses might be within the first limb of *Hadley v Baxendale* and should be specifically referred to in the relevant clause rather than simply relying on generic phrases such as “indirect and consequential” to include them.

Such clauses will not cease to apply when the contract is terminated for fundamental breach if that is the proper construction of the contract.\(^\text{14}\)

The enforceability of an exclusion of liability clause may also be impacted by legislation. For example, section 68 of the TPA renders invalid any contractual term purporting to exclude, restrict or modify the rights or liabilities in respect of conditions or warranties implied regarding goods and services supplied to a “consumer” (as defined under the TPA).

Similar legislative restrictions apply in various state jurisdictions. Section 40M of the Fair Trading Act 1987 (NSW) mirrors section 68 of the TPA and prohibits the exclusion, restriction or modification of the conditions and warranties statutorily provided under that Act in respect of consumer transactions. Section 64 of the Sale of Goods Act 1923 (NSW) invalidates a clause purporting to exclude, restrict or modify the rights of liabilities of a supplier in respect of a “consumer sale” (as defined under that Act).

In many jurisdictions pay when paid and pay if paid clauses in construction contracts are now rendered unenforceable.

It must be kept in mind that exclusion of liability and limitation of liability clauses will assist greatly in the allocation of risk between the parties to the contract but because of the doctrine of privity of contract may not be enforceable as against those persons who are not parties to the contract (except in limited circumstances where exceptions to the doctrine apply – as discussed in section 5.2). This doctrine must be kept firmly in mind when drafting contracts so as to ensure that the risk of claims by third parties are adequately

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\(^{14}\) See *Photo Production Ltd v Securicor Transport Ltd [1980] 2 WLR 283*
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dealt with by way of indemnities, if that is appropriate, as the exclusion of liability and limitation of liability clauses may not provide any protection. Of course, insurance contracts may also have some relevance in this regard and they should be kept clearly in mind when drafting the relevant indemnities. This is discussed further below.

4.3 Points to consider when drafting

Exclusion of liability and limitation of liability clauses are difficult to draft. It seems that in many cases lawyers and others simply use the exclusion of liability or limitation of liability clause which they previously (and often most recently) used in a contract. This can result in the relevant clauses not achieving their purpose because sufficient thought has not been given to the risk allocation to be achieved in the specific transaction.

The preferred approach is to:

- ascertain the liability which is likely to be attracted by a party;
- ascertain who is to bear the risk of the relevant liability;
- ascertain the liability to be excluded or limited.

Some practical points to consider when drafting exclusion and limitation of liability clauses include:

- It is important to determine and clearly specify in the clause the subject matter of the relevant clause, that is the liability to be excluded or limited. In this regard it will be necessary to identify whether:
  - the relevant duty is being excluded or limited;
  - a category of liability or damages is being excluded or limited;
  - claims made after a certain time are being excluded or limited; or
  - claims in excess of a certain value (in isolation or in aggregate) are being excluded or limited.

  In this context words such as "indirect" and "consequential" should not be seen as a panacea for all loss of revenue or other similar economic losses.

- Where it is a multi-party contract, it will be necessary to determine and clearly identify in the relevant clause the parties whose rights are being truncated. In this regard careful consideration should be given in drafting the clause to identify whether the clause should only affect (i.e. exclude or limit) claims brought directly by that party of the relevant nature or amount or whether it should include liability which is owed by another party to the contract to a third party. For example, if the clause is attempting to exclude liability for consequential and indirect losses including loss of revenue, etc consideration needs to be given to whether or not the clause should exclude or limit claims of a similar like made by third parties against the party who otherwise would seek to recover the relevant losses and amounts claimed. In this regard consideration should clearly be given to claims for contribution and whether or not they should be caught by the relevant clause. These issues need to be considered in the context of the
applicable insurance regime (if any) and in particular the cover provided to the innocent party.

- The impact of the relevant clause on rights of counter-claim and set off should also be considered. In some circumstances the parties may wish to preserve the right of the innocent party to raise such claims by way of set-off and counter-claim with or without certain exclusions and limitations.

- The rights of insurers require special consideration. Too often exclusion and limitation of liability clauses are accepted by parties without giving any consideration to the rights of insurers who may be subrogated to the rights of the innocent party, even though such clauses would prevent insurers from making claims against the defaulting party. Parties should seek the consent of relevant insurers before agreeing to any such clauses which are likely to affect their insurers’ rights of recovery.

- Reciprocal rights are often inserted in contracts without giving any consideration as to the need for them or the commercial implications. For example, in a construction contract a contractor will often seek to exclude liability for loss of revenue etc and an owner may seek a reciprocal clause in its favour. What is often overlooked is that in the event of a breach of the contract by the owner the very compensation which the contractor may seek by way of damages is compensation for its loss of profit on the remainder of the contract. If a like clause has been inserted in favour of the owner then this right to damages may be lost.

- Exceptions to the exclusion and limitation of liability clauses should be carefully considered. Typical exceptions include fraud, criminal or unlawful acts and omissions, wilful default, wilful damage, gross negligence (even though that may be a term which is not necessarily known at law and should be defined in the contract), claims for breach of intellectual property rights, amounts recovered under insurance policies (or sometimes amounts insured under policies) and amounts which would have been recovered by insurance but for a breach of the insurance policy by the defaulting party or a failure by that party to insure and amounts recovered from other parties. It is often appropriate to ensure that such exclusions are worded consistently with the exclusions under relevant insurance policies so that a party who is unable to rely on insurance is otherwise able to recover the loss.

Consideration might also be given to excepting claims from third parties (such as personal injuries and property damage claims) in certain circumstances. Once again, this is likely to depend on the insurance cover of the innocent party.

4.4 What to ask for and what to accept

What is commercially achievable in respect of any transaction by way of exclusions of liability and limitation of liability clauses will very much depend on the commercial context including the bargaining position of the parties and the commercial overlay including the
insurance regime. For example, it will be much easier for a party to obtain an exclusion or a limitation of liability in relation to consequential losses if the other party has effected business interruption insurance.

Therefore, it is difficult to give any precise direction as to what is obtainable in the abstract context of no particular transaction. However, it is possible to make some observations about recent trends. These include:

- Parties are focusing on exclusions of liability and limitation of liability clauses in all sorts of contracts particularly large projects where there is recourse to security provided by parties including parent company guarantees.

- It is becoming increasingly the norm that reciprocal rights as regards exclusions and limitation of liability clauses are being inserted in contracts. For the reasons outlined above this is not necessarily a sensible course and great care needs to be taken with this approach to distinguish between the different contractual positions of the parties.

- Typically contracts are excluding indirect losses, consequential losses, loss of revenue, loss of profit, loss of production, loss of goodwill, etc.

- Typically contracts are including overall caps on liability and caps on liquidated damages. These caps range from, in dollar terms, the likely value of the relevant party’s profit on the contract through to the total amount to be paid to the party or the amount which is likely to be insured or insurable by the defaulting party. In between there is a gradation and other amounts which have been included in contracts include the value of security (performance bonds) provided by the defaulting party, the amounts obtainable from third party suppliers or subcontractors and other amounts struck in negotiations.

- Contracts are including exclusions of liability in respect of claims which fall outside certain periods of time. These periods of time are normally equivalent to the relevant limitation of liability period and normally run for 6 years after completion of the relevant contract.

- The exclusions of liability and limitations of liability clauses are drafted so as to include claims for contribution in respect of similar claims made by third parties against the innocent party.

- As discussed above typical exceptions to exclusions of liability and limitations of liability include fraud, criminal acts and omissions, wilful default, wilful damage, gross negligence (even though that may be a term which is not necessarily known at law and should be defined in the contract), claims for breach of intellectual property rights, amounts recovered under insurance policies (or sometimes amounts insured under policies) and amounts which would have been recovered by insurance but for a breach of the insurance policy by the defaulting party or a failure by that party to insure and amounts recovered from other parties. Sometimes
the exceptions extend to claims from third parties (such as personal injuries and property damage claims), but the acceptability of this will depend on the insurance effected by or in favour of each of the parties.

- The exclusions of liability and limitation of liability clauses are sometimes supported in part by indemnities which seek to deal with some claims from third parties which are brought directly against the defaulting party. This is particularly the case if the innocent party can obtain appropriate exclusions or limitations or indemnities from the third parties or can protect itself by way of insurance.

5. Indemnities

5.1 What are they?

An indemnity is a promise by one party to hold the other party harmless against one or more losses sustained by the other party. It is usually linked to acts or omissions of the party giving the indemnity.

An obligation to indemnify must be distinguished from an obligation to guarantee. A guarantor’s liability is considered collateral or secondary whereas an indemnifier’s liability is considered primary.

A guarantor undertakes to ensure, in the event of a default by the contracting party, that a particular obligation under contract is fulfilled on the contracting party’s behalf. In contrast, an indemnity is a promise to make good a loss or keep another party free from harm.

5.2 Enforcement of Indemnities

Generally speaking, and assuming the contract in which the indemnity is contained is enforceable, an indemnity will, in the absence of uncertainty, some form of statutory prohibition or public policy considerations, be enforceable according to its terms.

In determining the enforceability of an indemnity, the courts will look to the specific words of the indemnity to construe the liability which arises. As an indemnity is not governed by the law relating to assessment of damages for breach of contract, factors such a remoteness and mitigation do not need to be proved.

The doctrine of privity of contract provides that except in very limited circumstances only parties to a contract can enforce contractual obligations. As an indemnity is a contractual obligation (in the absence of a statutory right of indemnity) only the parties to the relevant contract will receive the benefit of it. In more recent times indemnities have been drafted to provide for parties extra the contract (e.g. related corporations, officers, employees, agents, invitees, etc) to be included in the class of people to be indemnified under contractual indemnities. The question arises as to whether these indemnities are enforceable by those persons who are not parties to the contract.

15 Yeoman Credit Ltd v Latter (1961) 1 WLR 828
The court in *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107 held that an obligation to indemnify under an insurance contract could be enforced by a beneficiary of that obligation even though he or she was not a party to the contract.

In this case, McNiece was the principal contractor for a plant being constructed for Blue Circle Southern Cement Limited. Blue Circle had effected an insurance policy with Trident, which contained the following clause:

> The insurance ...indemnifies the Assured against all sums which the Assured shall become legally liable to pay in respect of:

> (1) Death of or bodily injury to or illness of any person not being a person who at the time of occurrence is engaged in and upon the service of the Assured under a contract of service or apprenticeship...” (where the Assured was described in the policy to include contractors and sub-contractors of Blue Circle).

A worker was injured while under the direction of a McNiece employee. The worker made a successful claim against McNiece who then sought an indemnity from Trident. The High Court accepted there was an exception to the doctrine of privity and found in favour of McNiece even though McNiece was not party to the insurance contract and had not provided any consideration.

The majority Judges adopted different bases for the exception.

Mason CJ and Toohey J created a limited exception to the doctrine of privity. Toohey J stated that "when an insurer issues a liability insurance policy, identifying the assured in terms that evidence an intention on part of both insurer and assured that the policy will indemnify those with whom the assured contracts for the purpose of the venture covered by the policy, and it is reasonable to expect that such a contractor may order its affairs by reference to the existence of the policy, the contractor may sue the insurer on the policy, notwithstanding that the contractor is not a party to the contract between the insurer and the assured.”

Gaudron J held stated that "a promisor who has accepted an agreed consideration for a promise to benefit a third party comes under an obligation to the third party to fulfil that promise and the third party acquires a right to bring an action to secure the benefit of that promise. The right of the third party is not a right to sue under the contract: rather it is an independent right of, but ordinarily corresponding in content and duration with, the obligation owed under the contract by the promisor to the promisee.” Guadron J appears to have decided on the basis of unjust enrichment.

Deane J decided in favour of McNiece on the basis of a trust of a promise.

In some cases statutes give recognition to allow enforceability of promises made for the benefit of third parties, but acceptance of the indemnity must be made by the relevant third parties. Accordingly, in these instances the third party should be advised of the indemnity and should accept it as soon as possible and accept it in a manner which conforms with the relevant legislative provisions.

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16 (1988) 165 CLR 107 at 536
17 ibid at 537-538
For example, Section 55 of the Property Law Act 1974 (QLD) provides an exception to the doctrine of privity as follows:

55 Contracts for the benefit of third parties

(1) A promisor who, for a valuable consideration moving from the promises, promises to do or to refrain from doing an act or acts for the benefit of a beneficiary shall, upon acceptance by the beneficiary, be subject to a duty enforceable by the beneficiary to perform that promise.

(2) Prior to acceptance the promisor and promisee may, without the consent of the beneficiary, vary or discharge the terms of the promise and any duty arising from it.

(3) Upon acceptance –
   (a) the beneficiary shall be entitled in the beneficiary's own name to such remedies and relief as may be just and convenient for the enforcement of the duty of the promisor, and relief by way of specific performance, injunction or otherwise shall not be refused solely on the ground that, as against the promisor, the beneficiary may be a volunteer; and
   (b) the beneficiary shall be bound by the promise and subject to a duty enforceable against the beneficiary in the beneficiary's own name to do or refrain from doing such act or acts (if any) as may by the terms of the promise be required of the beneficiary; and
   (c) the promisor shall be entitled to such remedies and relief as may be just and convenient for the enforcement of the duty of the beneficiary; and
   (d) the terms of the promise and the duty of the promisor or the beneficiary may be varied or discharged with the consent of the promisor and the beneficiary.

(4) Subject to subsection (1), any matter which would in proceedings not brought in reliance on this section render a promise void, voidable or unenforceable, whether wholly or in part, or which in proceedings (not brought in reliance on this section) to enforce a promissory duty arising from a promise is available by way of defence shall, in like manner and to the like extent, render void, voidable or unenforceable or be available by way of defence in proceedings for the enforcement of a duty to which this section gives effect.

(5) In so far as a duty to which this section gives effect may be capable of creating and creates an interest in land, such interest shall, subject to section 12, be capable of being created and of subsisting in land under any Act but subject to that Act.

6 Section 12 (Creation of interests in land by parol)

(6) In this section –
   "acceptance" means an assent by words or conduct communicated by or on behalf of the beneficiary to the promisor, or to some person authorised on the promisor's behalf, in the manner (if any), and within the time, specified in the promise or, if no time is specified, within a reasonable time of the promise coming to the notice of the beneficiary.

"beneficiary" means a person other than the promisor or promisee, and includes a person who, at the time of acceptance is identified and in existence, although that person may not have been identified or in existence at the time when the promise was given.

"promise" means a promise –
(a) which is or appears to be intended to be legally binding; and
(b) which created or appears to be intended to create a duty enforceable by a beneficiary;

and includes a promise whether made by deed, or in writing, or, subject to this Act, orally, or partly in writing and partly orally.

"promisee" means a person to whom a promise is made or given.

"promisor" means a person by whom a promise is made or given.

(7) Nothing in this section affects any right or remedy which exists or is available apart from this section.

(8) This section applies only to promises made after the commencement of this Act.

Therefore some possible exceptions to the doctrine of privity of contract include:

• third party beneficiaries by virtue of the common law or statutory rights given to such beneficiaries;
• where the indemnity has been received by the contracting party as agent for the other members of the class referred to in the indemnity;
• where the indemnity or the benefits of it are held on trust by the other contracting party for the benefit of the other beneficiaries.

5.3 Points to consider when drafting

As with the other clauses considered in this paper, there are many issues to consider when drafting these types of clauses. These issues include:

• Identifying the subjects and subject matter of the indemnities. It is important to identify who will provide the indemnity and to whom it will be provided, including any third parties. It is also important to identify the types of claims, demands, actions, liabilities, losses, costs or expenses to which the indemnity will apply and whether those categories of liability will also include claims by third parties made against the indemnified party for similar sorts of liabilities.

• Often reciprocal indemnities are included in contracts without any consideration given to whether this is appropriate. In some cases it may be appropriate whilst in others it might not. For example, where a contractor provides an indemnity to support the allocation to it of the care and risk of the works (i.e. physical structure to be handed over at the completion of the project) it is not appropriate for the owner to provide a similar indemnity in respect of the same risk.

• Consideration should be given to what should be excluded from the relevant indemnity. For example, it is common to exclude liabilities which arise due to the actions of the party seeking the benefit of the indemnity. Such liabilities would include those which arise by virtue of the relevant parties own negligence or breach of contract or breach of statutory duty.
• Sometimes indemnities will extend beyond the liability which a party will owe at common law, and consideration should be given to seeking consent from relevant insurers before agreeing to such indemnities. If such consent is not obtained then, depending on the wording of the relevant policy of insurance, insurers might be able to deny liability for the whole or part of the liabilities the subject of the indemnity.

• Interaction between the exclusions of liability and limitation of liability clauses, liquidated damages regimes and indemnity clauses needs to be carefully considered. For example, where the liability of a party is excluded or limited it might be appropriate to make the relevant indemnity subject to that exclusion or limitation. If this is the case then this should be made clear. Alternatively if that is not appropriate then the converse should also be made clear. Where a liquidated damages regime has been included in a contract and a broad indemnity for breach of contract is also included then consideration needs to be given as to whether the liquidated damages regime is still intended to operate as a limitation of liability in respect of the relevant breach irrespective of the relevant indemnity.

• Care needs to be taken when drafting indemnities for liability which might flow from breach of statutory obligations. If the contravention of the statute will amount to an offence and may attract the payment of a fine or penalty then it may not be possible to obtain an enforceable indemnity in respect of such fine or other statutory penalty.

5.4 What to ask for and what to accept

The indemnities which parties will agree to are very much, once again, dependent on the commercial context of the relevant contract, the parties bargaining positions and the insurance regime applicable to the relevant contract or project. It is not possible to provide a list of the indemnities which will or should be included in any particular contract. However, some observations can be made about some trends which have appeared in recent times in respect of indemnities. These include:

• It is now quite common for contracts to include indemnities in respect of liability owed to third parties for damage to property and personal injury where a party is providing works or services on or in connection with another party’s property. Often these clauses will exclude liability which arises due to the negligence, breach of contract or breach of statutory duty by the innocent party.

• Parties are becoming less willing to provide broad reaching indemnities for breaches of contract and are more likely to insist on the innocent party relying on its rights to damages at common law or its rights under liquidated damages regimes where such rights are subject to relevant exclusions of liability and limitations of liability.

• It is still quite common to see parties seeking indemnities in respect of breach of copyright and other intellectual property rights. Often these
Indemnities are open ended and are not subject to any limitations of liability or exclusions of liability.

- It is uncommon to see indemnities contained in contracts for consequential loss, indirect loss, loss of revenue, profit, etc.

- In appropriate circumstances indemnities are being drafted to apply to non-parties to the contract including related corporations, officers, employees and agents. This is particularly the case for indemnities contained in settlement agreements where they support releases given in respect of claims (e.g. upon settlement of litigation).

- Indemnities are often made subject to overall exclusions of liability and limitations of liability so that they do not annihilate those exclusions and limitations.

### 6. Conclusion

Warranties, liquidated damages clauses, exclusions and limitations of liability clauses and indemnities are wonderful tools for effecting risk allocation in contracts, but must be properly understood and clearly drafted.