Paris Energy Series

VI. Exclusion Clauses: Navigating the Minefield
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Introduction

In energy contracts, attempts are frequently made to exclude or limit the liability of one or more of the parties. Lawyers and business people alike will be familiar with the appearance of exclusion clauses, not least because we encounter them so often in the contracts we enter into every day as consumers. Exclusion clauses are some of the most important provisions in any agreement. They will always be among the most heavily scrutinised sections of a contract in the event a dispute develops. The success or failure of vast claims can (and often does) hinge on the question of whether a cap on damages applies or whether liability for a breach was effectively excluded.

This article begins by outlining the "natural limitations" that apply to claims for damages even where the parties have made no attempt to expressly exclude liability. Accepting the commercial incentives for energy industry players to attempt to limit their liability on the projects they undertake, this article broadly discusses the different types of exclusion clauses and approaches to their enforceability and application. It then examines some potential pitfalls in the drafting of exclusion clauses and explains how to avoid these. Each pitfall is divided into a section on 'Danger',[2] which explain why an exclusion clause may not necessarily achieve the desired result and 'Avoidance', which offer practical tips for avoiding the pitfall. The article concludes with some points to remember for parties dealing with exclusion clauses. While the focus is on exclusion clauses under English law and other common law systems, this article also aims to provide a comparison on certain points with a major civil law jurisdiction: France.

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1. "Natural" Limitations on Liability

Whether or not the parties include an exclusion clause, there will still be restrictions on the amount of damages that a claimant can recover. The purpose of contractual damages in English law is to put the claimant "so far as money can do it, in the same position as he would have been in had the contract been performed."[3] Depending on the governing law of the contract, courts and tribunals impose limitations on the recoverability of damages based on concepts such as foreseeability, remoteness, and indirect or consequential loss.

In English law, the test was famously set out in *Hadley v Baxendale*: a party can only recover damages for losses which arose "naturally from the breach" or "may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract".[4] Liability is therefore limited to damages arising from losses which were not too remote or were in the parties' contemplation at the time of the contract. Additional losses due to the "special circumstances" of one party will only be recoverable if the other party was aware of the special circumstances at the time of the contract.

Hadley v Baxendale is also the basis of the rules limiting contractual damages in the United States, Australia, Canada and many other common law jurisdictions.[5] In arbitration, it has been said that when deciding questions of recoverability of damages under common law rules, "arbitrators will not hesitate to quote the famous *Hadley v Baxendale* decision."[6]

By contrast, the purpose of contractual damages under French law is to restore the *status quo ante* so as to put the victim back to where it would have been had the breach never been committed. As a general rule, damages will be awarded only if the harm sustained is direct, personal, certain and foreseeable.

Article 1151 of the French Code Civil states that:

> "Even in the case where the non-performance of the agreement is due to the debtor's intentional breach, damages may include, with respect to the loss suffered by the creditor and the profit which he has been deprived of, only what is an **immediate and direct consequence** of the non-performance of the agreement."[7] (emphasis added)

Further, Article 1150 imposes a foreseeability requirement:

> "A debtor is liable only for damages which were foreseen or which could have been foreseen at the time of the contract, where it is not through his own intentional breach that the obligation is not fulfilled."[8]

French law thus uses terms similar to those in the common law rules. However, these restrictions go more towards what a common law lawyer might consider causation issues than limitation of indirect and consequential loss. Certain French cases show that, as long as the causal link is unbroken (or as long as there is *causalité adequate*, to use the French term), these restrictions do not always limit the recovery of such losses:

- In a case involving the supply of a defective engine for a rally car, the Court of Cassation allowed recovery of not only repair, but also reimbursement of the costs of finding alternative sponsors once the original sponsor decided to pull out.[9]
- In a case where a taxi driver failed to pick up clients who had earlier reserved a taxi to a train station (where they were to take a train to go to the airport in order to fly to Greece), the Dijon Court of Appeal held that the taxi company had to reimburse the cost of the entire trip to Greece.[10]

The Court of Cassation has recently, however, reacted to a string of decisions similar to the second example above by overturning a ruling that claimants, who missed a flight because their train was late, could recover the cost of their entire trip from the SNCF, the Court holding that actual foreseeability was needed for the damages to be recoverable.[11]

2. Contractual Exclusion of Liability

Unsurprisingly, parties often wish to go beyond the governing law of their contract and explicitly limit or exclude liability in their contracts. Risk allocation is a critical function of complex commercial contracts, especially energy contracts dealing with major long-term projects. This is truer still of energy contracts made in uncertain economic times, where the success of a venture can never be guaranteed and drafters must anticipate the unexpected.

There are many methods of distributing risk in energy contracts: liquidated damages clauses, mutual hold harmless indemnities and insurance provisions are all common features.[12] Nonetheless, the nature of exclusion clauses makes them a powerful tool. Exclusion clauses appear in many different forms and are given many different labels.[13] A clause may seek to:

- exclude or limit liability for a certain type of breach of contract;
- exclude or limit liability for a certain type of loss;
- limit total liability to a stated amount; and / or
- impose timing, procedural or other restrictions on a party's ability to claim.

A key question: are such clauses enforceable? As a starting point, the principle of freedom of contract, recognised across the common law[14] and civil law[15] worlds, means that parties can contract on whatever terms they wish and have their contracts enforced. Exclusion clauses are accepted as a legitimate method of allocating risk and achieving greater certainty. Courts and tribunals are generally prepared to enforce exclusion clauses of all four types described above.

However, national courts have recognised that exclusion clauses involve parties waiving the rights and remedies that contract law otherwise allows them, and sometimes result from an inequality of bargaining power. There is therefore a potential for abuse: the usual examples given are of individuals "signing their rights away" in contracts with large companies where the impenetrable "small print" includes wide-ranging exclusions of liability. National courts have therefore interpreted and applied exclusion clauses restrictively where there is any hint of injustice. Exclusion clauses have also been subject to legislative control in many countries.[16] Even the UNIDROIT Principles, "rules for international commercial contracts",[17] provide that an exclusion clause "may not be invoked if it would be grossly unfair to do so, having regard to the purpose of the contract."[18]

Of course, the arguments which demand protection of consumers from the potential excesses of exclusion clauses are less persuasive in the context of major energy companies contracting with each other on the advice of

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specialist counsel. Nonetheless, such parties should be aware of the "hostility" (as one court put it[19]) to exclusion clauses in many legal systems. This hostility is arguably a global phenomenon.[20] This creates a tension within the law of contract. Should the law give effect to an agreement's explicit wording? Or should it seek to redress the effects of an imbalance of bargaining power between the parties? This clash of rationales should be borne in mind when considering the drafting "pitfalls" below.

3. Exclusion Clause Pitfalls

Pitfall 1: Outright Prohibitions

The exclusion clause attempts to exclude a type of liability which the governing law of the contract does not permit.

Danger:

The governing law of the contract law may prohibit the parties from excluding liability for certain actions or types of loss. For example, English law does not allow a party to exclude liability for fraud. On the other hand, contractual liability for personal injury and property injury can be excluded in commercial contracts. This is not the case in several European civil law jurisdictions.

A contract prepared with counsel's assistance is unlikely to purport to exclude a liability which cannot be excluded. However, the temptation may exist to attempt to draft around a prohibition. Caution is advised here because a finding that an exclusion clause falls foul of a prohibition may carry unforeseen consequences. For example, in English law, any attempt to exclude liability for fraud in an entire agreement clause[21] may render the whole clause ineffective. Under New York law, not only is it impossible to exclude liability for gross negligence, but any gross negligence will in fact bar the enforcement of an exclusion clause.[22]

Under French domestic law, clauses purporting to exclude or limit tortious liability are unenforceable on public policy grounds[23] (although it may be possible to exclude or limit tortious liability in international contracts governed by French law[24]). Further, an exclusion clause cannot exclude liability for a breach of contract which constitutes wilful misconduct (*dol*) or gross negligence (*faute lourde*) and the same risk exists as under New York law: that the whole clause may be held unenforceable. The *"Chronopost"*[25] decisions of the Court of Cassation suggest the gross negligence rule will operate to make any exclusion clause unenforceable to the extent it seeks to exclude liability for the breach of an essential contractual obligation.[26] The Court in the recent *"Faurecia"*[27] case, on the other hand, adopted a more subjective approach, focussing on the "seriousness of the breaching party's conduct" under which a breach of an essential obligation is not in itself sufficient to constitute gross negligence.

Avoidance:

Parties should negotiate and draft exclusion clauses with an awareness of the types of liability that cannot be excluded under the governing law of the contract. Whilst not strictly necessary,[28] exclusion clauses often state that they make no attempt to exclude liabilities which cannot be excluded under the governing law of the contract, such as fraud in English law and gross negligence or wilful misconduct in French law. This can be a prudent step to take.

Pitfall 2: Strict Construction

The exclusion clause is ambiguous, unclear or vague.

Danger:

Under English law, there is a general rule of strict construction of exclusion clauses. The leading contract law text states that "exclusion clauses must clearly and unambiguously express the intentions of the parties or they will be held ineffective."[29] It gives the example of a case where the defendant sold the claimant an item "subject to our usual… guarantee clauses".[30] The "guarantee clause" in question was closer to an exclusion clause; it excluded liability for defects of material or workmanship discovered more than six months after delivery. The Court of Appeal held that the guarantee clause did not apply to the contract which purported to incorporate it because "if a person was under a legal liability and wished to get rid of it he could only do so by using clear words".

On a similar theme, in both English[31] and French[32] law, and in many other jurisdictions, exclusion clauses are interpreted *contra proferentem*. This means that any ambiguous term will be interpreted against the party who drafted the clause or instigated its inclusion.

Further, the English courts will also apply the principle[33] that unclear contracts should be interpreted in accordance with business common sense. In *Kudos Catering*,[34] the Court of Appeal found that, even where "apparently clear" words[35] were used in an exclusion clause, the context was such that the parties could not have intended to exclude liability for all financial loss. Given that a court would not have ordered

specific performance of the contract in question, construing the clause to exclude all liability would have left the contract "effectively devoid of contractual content since there is no sanction for non-performance".[36] The location of the clause in the 'Indemnity and Insurance' section and the words "loss suffered by the Contractor **or any third party**" (emphasis added) also led the Court of Appeal to the conclusion that the exclusion did not extend to "to losses suffered in consequence of a refusal to perform or to be bound by the Agreement". This case shows that the English courts will be reluctant to accept that commercial parties intended to agree an exclusion clause which leaves one party without a contractual remedy.

Avoidance:

Exclusion clauses should be unambiguous and exhaustive. Drafters should carefully consider the types of breach and loss at which the clause is aimed and frame and set out the clause as clearly as possible. If the parties have agreed a wide-ranging exclusion clause, it should be titled accordingly and placed in a separate section of the contract. Under English law, clauses which limit liability will be construed less strictly because courts and tribunals will be more ready to infer that the parties intended to limit liability than exclude it completely.[37] Parties should therefore give due consideration to whether a cap on damages would be more appropriate than an exclusion in some circumstances.

Pitfall 3: The Scope of the Exclusion

The exclusion clause does not cover the relevant breach or type of loss.

Danger:

Clearly, for a party to be able to invoke an exclusion clause, it must cover the exact breach or type of loss which occurred. The burden of proof is on the party invoking the clause to show that it applies to the liability and, as discussed above, any ambiguity or lack of clarity will go against it.

It can be difficult enough to formulate an effective exclusion clause for breaches of *express* terms. The law reports are full of examples of parties failing to exclude liability for breaches of *implied* terms, particularly the "satisfactory quality" term implied by Section 14(2) of the Sale of Goods Act 1979 (the **"SOGA"**).[38] One such example came in *The Mercini Lady*, which related to the delivery of a shipment of gasoil which was "on-spec" when examined at its first port of call but "off-spec" when examined at its destination four days later.[39] The exclusion clause stated that:

> *There are no guarantees, warranties or misrepresentations, express or implied, [of] merchantability, fitness or suitability of the oil for any particular purpose or otherwise which extend beyond the description of the oil set forth in this agreement.*

The English Court of Appeal held that this clause did not exclude liability for a potential breach of the "satisfactory quality" term implied by the SOGA. Section 14(2) of the SOGA implies that the goods sold must be of satisfactory quality as a condition of the contract (a fundamental term, the breach of which results in a repudiation of the contract). The finding of the Court of Appeal was that only by explicitly excluding "conditions" in the wording of the clause could one exclude liability for breach of this provision of the SOGA.

A decision of the High Court has, however, distinguished this finding and nonetheless held that an exclusion clause could be broad enough to exclude the SOGA implied term even without reference to "conditions".

English law is therefore in a state of flux on this point but it is evident that clarity is paramount. This is exemplified in a later High Court case[40] which required that the parties include a "clear and unequivocal statement of an alternative regime as to quality" which is "wholly inconsistent" with section 14(2) in order to exclude liability in this regard. In a case involving a dispute over a shipment of crude oil detained in Nigeria, the English High Court indicated that the following would be sufficiently "clear language" to exclude the implied term:

> *All other conditions, warranties, or other terms whether express, implied or which would otherwise be imposed by statute with respect to quality, satisfactory quality, suitability or fitness for any purpose whatsoever of the product are hereby excluded.*[41]

Although a contract may set out their commercial relationship and obligations in great detail, parties still owe each other legal duties outside the scope of the contract. For example, parties owe each other a concurrent duty of care in negligence alongside their contractual duties.[42] Under English law, it is considered "inherently improbable that one party to the contract should intend to absolve the other party from the consequences of the latter's own negligence."[43] Clear language is therefore needed to exclude liability for negligence.[44] The key principles were set out in *Canada Steamship Lines v The King*:[45]

- If a clause expressly exempts liability for negligence, it is effective.

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- If there is no express reference to negligence, the court must consider whether the words used are wide enough, in their ordinary meaning, to cover negligence. Any ambiguity will be construed *contra proferentem*. If the words used are wide enough to cover negligence but there is another plausible head of damage which the clause could have been intended to cover, the clause will not be effective.

In the United States, it is usually possible to exclude liability for negligence (but not for gross negligence[46]). It is generally not possible to contractually limit liability for tort under French law.[47]

Avoidance:

Drafters aiming for a watertight exclusion of specified breaches or types of loss should identify them carefully and describe them exhaustively. Long lists of exclusions can be considered inelegant drafting but may be helpful both in covering all of the liabilities intended and conveying the impression to a judge or arbitrator that the clause was intended to be a "catch all".[48]

While English law is unclear on the point, drafters should refer to express and implied conditions to be certain of excluding the "satisfactory quality" term implied by the SOGA.

Drafters should also be aware of the restrictive approach taken in English law to exclusion of liability for negligence. Clear language is again required and using the word "negligence" itself is preferable.

Pitfall 4: Indirect and Consequential Loss

The exclusion clause excludes liability for "indirect and consequential loss" and may contain an "including but not limited to" formulation.

The first problem with the term "indirect and consequential loss" is a fundamental one: no-one agrees on what it means. Even within the common law world, there are divergent views on the matter. This is examined in detail in the authoritative English practitioner's text: *McGregor on Damages*, the current edition of which devotes two paragraphs to explaining why the leading Court of Appeal authority[49] on consequential loss in exclusion clauses is wrong and its own analysis is right.[50] The Court of Appeal has equated the term "indirect[51] and consequential loss" with loss recoverable under the second limb of *Hadley v Baxendale* (losses due to the "special circumstances" of the party). However, McGregor argues that consequential loss is actually anything beyond the effective "market value" of the breach and, as such, can still fall into the first limb of *Hadley v Baxendale* (natural consequences of the breach). The McGregor analysis has some logical appeal and has been accepted by the Australian courts[52] but is still at odds with the English courts and also, it would seem, US case law on this matter.[53]

Aside from this academic debate, the interesting point for the practitioner is the prevailing case law. Many of the authorities follow the same formula: exclusion clause limits liability for consequential losses; offending party breaches contract, resulting in lost profits, and attempts to rely on the exclusion clause; court finds that the lost profits flowed directly from the breach, were not consequential losses and were not therefore excluded.[54] It is clear that the English courts, whether they acknowledge it or not,[55] are taking a pragmatic approach and determining cases based on the foreseeability of the damage caused.

"Including but not limited to" language is often used to introduce a list where the drafter wishes to specify items without limiting the generality of the introductory term or phrase. However, its misuse in an exclusion clause is a trap for the unwary. The English courts have held that where a clause limits liability for "indirect, special or consequential loss, howsoever arising (including but not limited to loss of anticipated profits or of data)",[56] the specified items of loss will only be excluded if they are themselves indirect or consequential in nature. In other words, if loss of profits flowed naturally and directly from the breach and no "special circumstances" were involved, they would not necessarily be excluded by this clause.

A similar issue arises where a list ends with the phrase "or any other indirect and consequential loss". The word "other" limits the scope of the listed items to indirect or consequential loss and should be omitted if the parties have agreed to exclude liability for the specified items of loss in all circumstances. The recent cases of *Fujitsu v IBM*[57] and *Polypearl Limited v E.on Energy Solutions Limited*[58] have served to emphasise the cogency of this advice in relation to claims for loss of profits and exemplify why an exclusion clause under English law must be absolutely explicit in its language when seeking to exclude liability for this head of loss.

The clause in *Fujitsu v IBM* reads as follows:

> *20.7 Neither Party shall be liable to the other under this Sub-Contract for loss of profits, revenue, business, goodwill, indirect or consequential loss or damage…*

The question before the High Court was whether the clause effectively excluded IBM's liability for all loss of profits (i.e. both direct and indirect) or only indirect loss of profits. The Court held that the reference to "loss of profits" in the clause did not make loss of profits a "sub-set" of indirect or consequential loss, with the result that the only profits which could be excluded were lost indirect profits.[59] Justice Carr was definitive in his reasoning when stating that "the language of clause 20.7 is on its face clear and unambiguous. Liability for loss of profits is excluded."[60] His Honour also emphasized that "one would expect it to be made clear if the intention was only to exclude indirect loss of profit"[61] and any other interpretation of the clause would "render otiose the words 'loss of profits, revenue, business goodwill'."[62] It was clear on the face of the clause that lost profits were a head of loss which was properly excluded in its own right.

The same issue of construction arose in *Polypearl*. The clause to be considered by Judge Behrens in that case read:

> *10.1) Neither party will be liable to the other for* ***any indirect or consequential loss, (both of which include, without limitation, pure economic loss, loss of profit, loss of business, depletion of goodwill and like loss)*** *howsoever caused (including as a result of negligence) under this Agreement, except in so far as it relates to personal injury or death caused by negligence.* (Emphasis added).

Again, did this language mean that only indirect or consequential loss of profit was excluded? In this case, *yes*. It was held that "the words in clause 10.1 do not clearly indicate that the parties intend to abandon a claim for direct loss of profits" and that this interpretation was more in keeping with business common sense.[63]

Contortion of the language and meaning of an exclusion clause is a common consequence of the rules of contractual interpretation in this area of law – the overall aim being to give effect to the parties' intentions.[64] Yet the Court of Appeal has recently held true to the doctrine of freedom of contract and overruled a judge of the High Court for his application of the *contra proferentem* principle. *Transocean Drilling UK Ltd v Providence Resources plc*[65] concerned the appeal by an owner of a semi-submersible oil-drilling rig against that part of the judgment at first instance which had found that the hirer was entitled to recover "spread costs" as consequential losses incurred as a result of delay caused by the owner's failure to provide the rig in good working order.

The exclusion clause in *Transocean* formed part of a heavily negotiated scheme of 'knock-for-knock' provisions included within an amended standard industry agreement known as the 'LOGIC' form. The judgment of the Court of Appeal made clear that the clause was not "a simple exclusion clause of a kind which at one time the courts were willing to construe restrictively in order to avoid commercial oppression".[66] Rather the clause was one which formed part of a scheme of complex clauses which were heavily negotiated by parties of equal bargaining power who had freely entered into mutual undertakings to accept the risk of consequential loss flowing from each other's breaches of contract. The mutual nature of the knock-for-knock scheme showed an intention to give the words a broad meaning which was apt to include wasted "spread costs" as consequential losses.[67] And finally, it was held that the judge had erred in invoking the *contra proferentem* principle, the application of which was inappropriate where the meaning of the words was clear, or where a clause favoured both parties equally, especially where they were of equal bargaining power.[68]

The *Transocean* decision is a timely reminder of the English adherence to the freedom of contract doctrine. And while the English courts are willing to be drawn into difficult exercises of contractual interpretation in the face of ambiguous exclusions of consequential loss, they will likely not do so where the wording of the contract can be relied upon to speak for itself, *i.e.* where it has been specifically agreed by commercially competent parties of equal bargaining power.

In the final section of his excellent article on the exclusion of consequential damages, Gregory Odry examines the challenges for a French judge dealing with an exclusion clause drafted in English but governed by French law, the governing law of the contract.[69] Odry's analysis uses a hypothetical judge, but he might well have chosen a hypothetical arbitrator; these are issues with which tribunals regularly have to deal. Odry notes that problems arise where parties use a phrase like "indirect and consequential loss" which is loaded with meaning under English law but may be construed differently by a lawyer from another legal system applying another governing law. Where translations are needed, this complicates matters even further.

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Danger:

Ambiguous references to "indirect or consequential loss" in an exclusion clause have been held by the English courts to colour the types of loss which may properly be excluded by it.[70] Where it is unclear whether the purportedly excluded lost profits include *all* profits or simply those *indirect* profits which form part of the broader umbrella term "indirect or consequential loss", the English courts are inclined to find the latter. Parties seeking to curtail their exposure under a contract therefore risk finding themselves liable to pay damages for lost "direct" profits in situations where they had expected to pay nothing.

Avoidance:

As the above cases demonstrate, the courts will enforce clear and unambiguous wording which serves to exclude a particular type of loss. This is best achieved by divorcing this language from the problematic phrase "indirect or consequential loss" as this nullifies the risk of any ambiguity of interpretation. Drafters may also wish to consider including a "for the avoidance of doubt" statement to clarify the parties' intentions. Standard forms should be reviewed and updated to reflect developments in the case law.

Pitfall 5: Liquidated Damages and Penalty Clauses

The liquidated damages clause is susceptible to being held to be void as a penalty.

English law has long held to the doctrine of freedom of contract: that parties are free to contract on the terms they see fit and shall be held to those terms. Yet the common law recognised that there needed to be exceptions to this doctrine due to the potential imposition of unduly onerous terms on, for example, a weaker party suffering under an inequality of bargaining power.[71]

As discussed in Section 2 above, one particularly notable exception to the notion of freedom of contract concerns the nature of liquidated damages clauses (**"LDCs"**). Commercial parties are often keen to obtain certainty as to their potential liability in the event of a breach, and to avoid the need to resort to litigation in order to receive compensation for it. The English courts have, however, long been wary of LDCs[72] and are alive to the possibility that a party to a contract may be forced to pay far more in compensation for a breach of contract under an LDC than he or she otherwise would through the ordinary operation of the law of damages. In those instances in which the courts declare an LDC to be an invalid "penalty clause", the ordinary consequence is that the clause will be held void and the claimant will have to rely on the ordinary operation of the law of damages.[73]

How to identify a penalty clause and whether the Court should permit it to be enforced are matters which have proved difficult for the judiciary to deal with in consistent fashion. Until recently, the leading case on these fronts was *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*[74] in which Lord Dunedin formulated a clarificatory test.[75] He stated that the provision would be considered penal if "the sum stipulated for is extravagant and unconscionable in amount in comparison to the greatest loss that could conceivably be proved to have followed from the breach".[76]

While his Lordship did elaborate on this basic measure, the case law surrounding the identification of penalty clauses developed on the basis that an LDC must be a "genuine pre-estimate of damage"[77] such that the question to be asked was: *Does this LDC afford the innocent party exorbitant compensation compared to what he would have achieved under the law of damages?*[78] The Courts were concerned not to allow a party to effectively coerce another to perform under a contract through the means of an unduly onerous LDC, and were skeptical of the legitimacy of a deterrence-based justification.[79] What this thinking failed to consider, however, is whether parties could *ever* have a legitimate interest in creating a deterrent within the contract. After all, don't damages themselves deter a breach of contract and encourage performance?

The Supreme Court in the recent case of *Cavendish Square Holding BC v Makdessi*[80] has revamped this confused reasoning in what is a landmark development in this area of law. The appeal was heard in conjunction with another case, *ParkingEye Limited v Beavis* (discussed below). *Cavendish* concerned two clauses in a substantial commercial contract. Under this contract Mr Makdessi and Mr Ghossoub agreed to sell shares in the holding company of a group of companies founded by Mr Makdessi. Those shares were then transferred to Cavendish Square Holdings BV which also became a party to the original agreement. Mr Makdessi was then accused by Cavendish of being in breach of the restrictive covenants contained in the agreement and took advantage of the clauses allowing it not to make payments to Mr Makdessi and to purchase his shares . The issue to be decided was, therefore, whether the clauses permitting the

retention of payment and forcing Mr Makdessi to exercise a call option through which he would sell his shares to Cavendish were enforceable – the penal nature of the clause being that Mr Makdessi would have to part with his shares for no remuneration. The clauses were held to be valid and enforceable at first instance but the Court of Appeal reversed this decision.

The second case, *ParkingEye*, involved a dispute between Mr Beavis and the manager of a car park, ParkingEye. Mr Beavis refused to pay an £85 charge for leaving his vehicle in the car park beyond the two-hour time limit. One of the grounds on which Mr Beavis refused was that the charge was unenforceable at common law because it constituted a penalty. Mr Beavis' arguments were rejected both at first instance and on appeal to the Court of Appeal.

The Supreme Court, sitting as a seven member panel[81] , allowed the appeal in *Cavendish* and dismissed the appeal in *ParkingEye*[82] (in each case enforcing the LDC). The majority of the Court[83] reasoned that the test for identifying penalty clauses was:

(i) whether the clause serves any legitimate interest; and, if so,

(ii) whether the provision made for that interest is in any way exorbitant or unconscionable.

Note that the exorbitance or unconscionability of the clause is measured against the legitimate interest of the innocent party and not what that party could expect to have obtained through the application of the law of damages. Furthermore, the Court found that this new test could apply to clauses other than LDCs which also have the effect of inflicting a financial detriment on a party. (The withholding of payment and the forced exercise of a call option in *Cavendish* are examples of this).

Lords Neuberger and Sumption delivered a joint judgment and formulated the test in slightly different terms. Their Lordships agreed with the above test but went further in stating that only "secondary obligations" are capable of being a penalty. They distinguished primary and secondary obligations as follows:

> *…where a contract contains an obligation on one party to perform an act, and also provides that, if he does perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which is capable of being a penalty; but if the contract does not impose (expressly or impliedly) an obligation to perform an act, but simply provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation and cannot be a penalty.*[84]

By adding this further hurdle, it would appear their Lordships sought to give parties greater licence to agree the terms they please and bring the state of the law in this area in line with the initial historical origins of the penalty rule (which are too detailed to be fully expressed in this update).[85] It remains to be seen whether the Courts will follow the more nuanced route laid out by Lords Neuberger and Sumption.

The judgments of their Lordships were all at pains to point out that a contractual provision which could not be fairly viewed as a genuine pre-estimate of loss could, in fact, be a valid and enforceable one provided the innocent party has a legitimate interest in its insertion into the contract. The Court also made it evident that one could have a legitimate interest in a deterrent provision.[86] Lords Neuberger and Sumption acutely summarized the position of the Court regarding the previous state of the law in stating that:

> *The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not therefore, at any rate without more, mean that it is penal. To describe it as a deterrent… does not add anything. A deterrent provision in a contract is simply one species of provision designed to influence the conduct of the party potentially affected. It is no different from a contractual inducement. Neither is it inherently penal or contrary to the policy of the law.*

While their Lordships came to their answers via slightly different reasoning, their verdicts were the same: neither contractual provision was penal[87]. In *Cavendish* both clauses were held to serve Cavendish's legitimate interest in protecting its investment and the nature of the clauses were neither exorbitant nor unconscionable in this regard, particularly given that the clauses were negotiated by well advised, commercially savvy parties[88]. In *ParkingEye* their Lordships recognised that while the £85 charge had the character of a deterrent penalty, as explained above, this was held to be no barrier to the enforceability of the charge,

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given the legitimate interest the manager had in the efficient use of the car park, and was held not to be manifestly excessive in its amount.

In French law, LDCs specifying the amount of damages for breach of contract are (confusingly for English speakers) referred to as *clauses pénales*. Article 1152 of the Code Civil upholds LDCs in the following terms:

> *Where an agreement provides that he who fails to perform it will pay a certain sum as damages, the other party may not be awarded a greater or lesser sum.*[89]

However, Article 1152 also provides that a judge may reduce or raise the agreed sum of damages "where it is manifestly excessive or insufficient"[90] to accord with the level of actual loss. This judicial power cannot be contracted out of by the parties. It is likely that a tribunal applying French law as the substantive law in arbitral proceedings would also consider itself able to modify a *clause pénale* in the same way. The difference between English and French law on this issue is noteworthy. While English law post-*Cavendish* permits one to legitimately enforce an LDC clause that is not a genuine pre-estimate of damages, the policy of French law remains tied to this notion by vesting judges with the power to alter the damages awarded pursuant to freely negotiated bargains to conform more closely to that which would be won through the ordinary application of the law of damages.[91]

Danger:

The amount of compensation afforded by an LDC in a contract can still be amended by the English courts where that amount cannot be justified in the face of the innocent party's legitimate interest in the LDC. Yet those seeking to encourage performance by their co-contractor can now argue that LDCs which seek to act as deterrents under the contract are enforceable provided they are able to show why such a deterrent is needed and that it is proportionate to their legitimate interest.

Avoidance:

When drafting an LDC, one should be mindful of the nature of the client's legitimate interest in the clause's inclusion in the contract. Firstly one should ask: *Does the party have a legitimate interest in including this LDC?* And secondly: *Does this clause provide what a fair-minded person would consider to be compensation which is commensurate with that party's legitimate interest?*

4. Key Points

In summation, when seeking to limit or exclude one's liability under a contract, one should take note of the following points.

- Be aware of the "natural" limits on recoverable damages under the governing law of the contract will assist in the drafting of an exclusion clause.
- Consider the difference between clauses which limit actions (for example, in contract or tort) and clauses which limit recovery (complete exclusions versus liability caps). Bear in mind that courts and tribunals may be more sympathetic to limitations of liability than to exclusions of liability.
- These types of clauses may be more likely to be effective where one can point to an acknowledgement of equality of bargaining power between the parties.
- Certain types of damage and liability cannot be excluded; others can be limited but not excluded. The governing law of the contract determines what can be done, underlining the need to carefully consider choice of law.
- Make no assumptions as to the meanings of terms of art such as "indirect" and "consequential". There is no consensus as to the precise meanings of these terms, even within jurisdictions.
- Be wary of embellishing clauses with additional phrases such as "including but not limited to" and "or other indirect and consequential loss" as they may have unexpected consequences.
- Consider the nature of your legitimate interest when looking to include a liquidated damages clause in a contract.
- Keep in mind that a liquidated damages clause that goes beyond providing compensation commensurate with the innocent party's legitimate interest in the clause will be held void by a court or tribunal.

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Endnotes

1 With thanks to Kieran Anderson for his contribution to the updated version.
2 In a dispute, a danger or risk for one party is always an opportunity for the other and these sections can also be read from the perspective of a party seeking to challenge the enforceability or applicability of exclusion clauses.
3 McGregor on Damages, 18th Edn., 1-023.
4 (1854) 156 ER 145. See also the restatement of the *Hadley v Baxendale* principles in *Victoria Laundry v Newman* [1949] 2 KB 528.
5 See, for example, in respect of the United States, the Superior Court of Los Angeles County in *Applied Equipment Corp. v Litton Saudi Arabia Ltd.* (1994) P.2d 454, 460: "Contract damages are generally limited to those within the contemplation of the parties when the contract was entered into or at least reasonably foreseeable by them at that time."
6 Paul-A. Gelinas, 'General Characteristics of Recoverable Damages in International Arbitration', in Evaluation of Damages in International Arbitration, Dossier of the ICC Institute of World Business Law, ed. Derains & Kreindler (Paris, ICC Publishing, 2006), 14.
7 Legifrance translation. French original: "Dans le cas même où l'inexécution de la convention résulte du dol du débiteur, les dommages et intérêts ne doivent comprendre à l'égard de la perte éprouvée par le créancier et du gain dont il a été privé que ce qui est une suite immédiate et directe de l'inexécution de la convention." Gelinas, op. cit., 15, notes that: "[w]ording to the same effect is found in the laws of most countries that belong to a continental or civil system of law."
8 Legifrance translation. French original: "Le débiteur n'est tenu que des dommages et intérêts qui ont été prévus ou qu'on a pu prévoir lors du contrat, lorsque ce n'est point par son dol que l'obligation n'est point exécutée."
9 Commercial Chamber of the Court of Cassation, 13 February 2007, n°05-21636.
10 Dijon Court of Appeal, 7 October 2003.
11 First Civil Chamber of the Court of Cassation, 28 April 2011, n°10-15056, discussed in Gregory Odry, 'Exclusion of Consequential Damages: Write What You Mean', [2012] ICLR 142, 159.
12 Chijioke S. Ugwuanyi, 'Examining the exclusionary nature of oil and gas contract mutual indemnity hold harmless clauses' [2012] 4 IELR 136 and Peter Cameron, 'Liability for catastrophic risk in the oil and gas industry', [2012] 6 IELR 207 are recommended for further details.
13 These include "exemption clauses", "limitation clauses", "exculpatory provisons" and (in common parlance) "the small print".
14 See, for example, Lord Reid *in Suisse Atlantique Societe d'Armement SA v NV Rotterdamsche Kolen Centrale* [1967] 1 AC 361, 399, referring to the "general principle of English law that parties are free to contract as they may think fit".
15 See paragraph 12 and footnote 16 of the Société de Legislation Comparée's 'Guiding Principles of European Contract Law', which identifies, for 11 EU member states, the provision of the constitution or civil code setting out this principle.
16 For example, the UK's Unfair Contracts Terms Act 1977 (**"UCTA"**) imposes a requirement of reasonableness on exclusion clauses in contracts made on one party's standard terms or where one party deals as a consumer. UCTA applies to very few energy industry contracts as they will generally not meet these conditions. Many energy contracts will also fall into the exclusions for international supply contracts (Section 26) or contracts where English law applies only by virtue of the parties' choice (Section 27).
17 Preamble, UNIDROIT Principles 2010, emphasis added.
18 Article 7.1.6 (*Exemption Clauses*), UNIDROIT Principles 2010.
19 This term is used to describe the approach of the English courts to exclusion clauses by Lord Wilberforce in *Ailsa Craig Fishing Co Ltd v Malvern Fishing Co Ltd* [1983] 1 WLR 964, 966.
20 See, for example, Cameron, op. cit., 217, "In India, for example, the courts do not generally like exclusion clauses."
21 An entire agreement clause is a type of exclusion clause which primarily aims to limit liability for misrepresentation.
22 *Odry* op. cit., 156.
23 Second Civil Chamber of the Court of Cassation, 17 February 1955: "Sont nulles les clauses d'exonération ou d'atténuation de responsabilité en matière délictuelle, les articles 1382 et 1383 du Code civil étant d'ordre public." (Author's translation: "Clauses purporting to exclude or limit liability for tort are null and void, Articles 1382 and 1383 of the Code Civil being a matter of public policy.")
24 The extent to which French domestic public policy concerns will apply to international contracts is unclear. Some French courts have held that contractual provisions will overrule the French *lex contractus*, especially when the place of performance is outside France (See Paris Court of Appeals, 19 June 1970, *Hecht v Soc. Buisman's*, Paris Court of Appeals, 15 September 1987, D. 1987, inf. Rap., 19).
25 Joint Chamber of the Court of Cassation, 22 April 2005, JCP 2005.I.149 n°3 Note Viney; Commercial Chamber of the Court of Cassation, 21 February 2006, Recueil Dalloz 2006 n°10, 717; Commercial Chamber of the Court of Cassation, 30 May 2006, Recueil Dalloz 2006 n°33, 2288; Commercial Chamber of the Court of Cassation, 13 June 2006, Revue Lamy Droit Civil, October 2006, n° 31, 17.

VI. Exclusion Clauses: Navigating the Minefield

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26 This doctrine bears similarities to the "fundamental breach" rule, which persisted in English law until rejected in *Photo Production Ltd v Securicor* [1980] AC 827. In *AstraZeneca UK Ltd v Albermarle International Corporation* [2011] EWHC 1574 (Comm), the decision in *Internet Broadcasting Corporation v MAR LLC* [2009] EWHC 744 (Ch) was criticised as being "wrong on the modern authorities" and effectively seeking to revive the "fundamental breach" rule.
27 Commercial Chamber of the Court of Cassation, 28 June 2005, n°09-11.841 (French original: "attendu que la faute lourde ne peut résulter du seul manquement à une obligation contractuelle, fût-elle essentielle, mais doit se déduire de la gravité du comportement du débiteur… seule est réputée non écrite la clause limitative de réparation qui contredit la portée de l'obligation essentielle souscrite par le débiteur").
28 Under English law at least: see *Regus (UK) Limited v Epcot Solutions Limited* [2008] EWCA Civ 361.
29 Chitty on Contracts, 31st Edn, 14-005.
30 *J. Gordon Alison & Co Ltd v Wallsend Shipway and Engineering Co Ltd* (1927) 27 Lloyds Rep. 285.
31 *Ailsa Craig Fishing Co Ltd v Malvern Fishing Co Ltd* [1983] 1 WLR 964, 966.
32 Article 1162 of the Code Civil: "In case of doubt, an agreement shall be interpreted against the one who has stipulated, and in favour of the one who has contracted the obligation." (Legifrance translation. French original: "Dans le doute, la convention s'interprète contre celui qui a stipulé et en faveur de celui qui a contracté l'obligation.")
33 See, for example, *Rainy Sky SA and others v Kookmin Bank* [2011] UKSC 50.
34 *Kudos Catering (UK) Ltd v Manchester Central Convention Complex Ltd* [2013] EWCA Civ 38.
35 The exclusion clause read: "The Contractor hereby acknowledges and agrees that the company shall have no liability whatsoever in contract, tort (including negligence) or otherwise for any loss of goodwill, business, revenue or profits, anticipated savings or wasted expenditure (whether reasonably foreseeable or not) or indirect or consequential loss suffered by the Contractor or any third party in relation to this Agreement…"
36 *Kudos Catering (UK) Ltd v Manchester Central Convention Complex Ltd* [2013] EWCA Civ 38, paragraph 19.
37 *Ailsa Craig Fishing Co Ltd v Malvern Fishing Co Ltd* [1983] 1 WLR 964, 970.
38 The SOGA has a broader application than UCTA (see footnote 15 above). There are no comparable exemptions to the international supply contracts or choice of law provisions in UCTA and it is generally accepted that the SOGA applies to international oil and gas sales. See *Great Elephant Corp v Trafigura Beheer BV* [2012] EWHC 1745 (Comm) for a recent example of the application of the SOGA to a sale of crude oil.
39 *KG Bominflot Bunkergesellschaft für Mineraloele mbH & Co v Petroplus Marketing AG, "The Mercini Lady"* [2010] EWCA Civ 1145.
40 *Dalmare SpA -v- (1) Union Maritime Ltd (2) Valor Shipping Ltd (The Union Power)* [2012] EWHC 3537 (Comm)
41 *Great Elephant Corp v Trafigura Beheer BV* [2012] EWHC 1745 (Comm), paragraph 90.
42 Clerk & Lindsell on Torts 20th Edn., Chapter 8 (Negligence), Section 2 (Duty of Care), Sub-section (ii) (Relevant Factors), Sub-section (3) (Reasonable Reliance or Dependence).
43 Buckley LJ in *Gillespie Bros & Co Ltd v Roy Bowles Transport Ltd* [1973] QB 400, 419.
44 Benjamin's Sale of Goods, 8th Edn.,13-022.
45 [1952] AC 192. Note that these principles provide "helpful guidance", not cast-iron rules or a "litmus test" (*HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2003] UKHL 6, paragraph 11).
46 See Pitfall 1 above. English law does not fully recognise a concept of gross negligence.
47 However, this rule may not apply in the case of international contracts. See Pitfall 1 above.
48 Beware, however, the potential problems with "indirect or consequential loss, including…" clauses. See Pitfall 4 below.
49 *British Sugar v NEI Power Projects* (1998) 87 BLR 42, *Deepak Fertilisers and Petrochemicals Corp v ICI Chemicals & Polymers* [1999] 1 Lloyd's Rep. 387, *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] BLR 235 and *Watford Electronics Ltd v Sanderson CFL Ltd* [2001] BLR 143.
50 McGregor on Damages, 18th Edn., 1-037-1-038.
51 It is generally accepted (in English law that "indirect" is synonymous with "consequential" in this context. See Atkinson J in *Saint Line Ltd v Richardsons, Westgarth & Co.* [1940] 2 KB 99, 103 and *Markerstudy Insurance Company Ltd & Ors v Endsleigh Insurance Services Ltd* [2009] EWHC 281. This is not necessarily the case in the United States.
52 *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26.
53 *Odry*, op. cit, 152.
54 See *British Sugar v NEI Power Projects* (1998) 87 BLR 42, *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] BLR 235, *Pegler Limited v Wang (UK) Limited (No.1)* [2000] BLR 218 and *GB Gas Holdings Ltd v Accenture (UK) Ltd* [2010] EWCA Civ 912.
55 The inference to be drawn is that the English courts are reluctant to acknowledge a reliance on foreseeability, perhaps for fear of disturbing the sacrosanct two-limb test from *Hadley v Baxendale*.
56 This example is from *Pegler Ltd v Wang (UK) Ltd (No.1)* [2000] BLR 218.
57 [2014] EWHC 752
58 [2014] EWHC 3045
59 [2014] EWHC 752, [76].
60 *Ibid*, [35].
61 *Ibid*, [77].
62 *Ibid*, [79].
63 [2014] EWHC 3045, [68]. See *Kudos Catering (UK) Limited v Manchester Central Convention Complex Limited* [2013] EWCA Civ 38 on the matter of business common sense interpretation, discussed in the original version of this article.
64 See *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 for a general discussion of the pros and cons such methods of contractual interpretation. See also Moore-Bick LJ in giving the judgment of the Court of Appeal in *Transocean Drilling UK Ltd v Providence Resources plc* [2016] EWCA Civ 372, at [23].
65 [2016] EWCA Civ 372.
66 *Ibid*, [14].
67 *Ibid*, [14] – [18].
68 *Ibid*, [20].
69 *Odry*, op. cit, 160.

70 See also *Pegler Ltd v Wang (UK) Ltd (No.1)* [2000] BLR 218.
71 See generally : *Robertson v Driver's Trustees* (1881) 8 R 555, the *Forest & Barr* case 8 M 187 and *Betts v Burch* (1859) 4 H & N 506. And as to the equitable origins of the law against penalties under English common law, see the joint judgment of Neuberger PSC and Sumption JSC in *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67, [4] – [11].
72 As early as 1863 Lord Justice Clerk asserted that "Parties cannot lawfully enter into an agreement that the one party shall be punished at the suit of other": *Craig v McBeath* (1863) 1 M 1020, 1022
73 The measure being that which is needed to put the claimant "so far as money can do it, in the same position as he would have been in had the contract been performed." McGregor on Damages, 18th Edition, 1-023.
74 [1915] AC 79.
75 Lord Dunedin's intention does not appear to have been to set out a single, definitive means by which to identify penalty clauses but rather to make clear a possible four-part test "which if applicable to the case under consideration may prove helpful, or even conclusive": [1915] AC 70, 87.
76 *Ibid.*
77 *Ibid*, 62.
78 This is the present author's assessment of the rationale underpinning the case law. To see the development of the common law post-*Dunlop*, see generally *Legione v Hateley* (1983) 152 CLR 406 and the judgment of Diplock LJ in *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428.
79 See Lord Halsbury's assessment of a penalty clause as a threat "to be enforced *in terrorem*" in *Elphinstone v Monkland Iron & Coal Co Ltd (1886) 11 App Cas 332, 348* and Lord Dunedin's repetition of the phrase in *Dunlop* [1915] AC 79, 86.
80 [2015] UKSC 67
81 Lord Neuberger (President), Lord Sumption, Lord Mance, Lord Clarke, Lord Carnwath, Lord Hodge and Lord Toulson.
82 Lord Toulson dissenting on the outcome in *ParkingEye* on the basis that the charge fell foul of the Unfair Terms in Consumer Contracts Regulations 1999.
83 Lords Hodge and Mance delivered concurring judgments on this point, with Lords Toulson and Carnwath in agreement.
84 [2015] UKSC 67, [13B-C].
85 See [2015] UKSC 67, [4] – [18].
86 Lords Neuberger and Sumption acutely summarized the position of the Court regarding the previous state of the law in stating that:
The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not therefore, at any rate without more, mean that it is penal. To describe it as a deterrent… does not add anything. A deterrent provision in a contract is simply one species of provision designed to influence the conduct of the party potentially affected. It is no different from a contractual inducement. Neither is it inherently penal or contrary to the policy of the law.
87 As noted above, Lord Toulson dissented as to the legality of the provision in *ParkingEye* per the application of the Unfair Terms in Consumer Contracts Regulations 1999. But he agreed with Lords Mance and Hodge on the issue of whether the provision constituted a penalty clause.
88 The Court placed much emphasis on the fact that contracts between commercial parties of comparable bargaining power should be upheld and that such parties are their own best judges of what is fair protection of their legitimate interests. See Lords Neuberger and Sumption at [2015] UKSC 67, [35F].
89 French original: "Lorsque la convention porte que celui qui manquera de l'exécuter payera une certaine somme à titre de dommages-intérêts, il ne peut être alloué à l'autre partie une somme plus forte, ni moindre. Néanmoins, le juge peut, même d'office, modérer ou augmenter la peine qui avait été convenue, si elle est manifestement excessive ou dérisoire. Toute stipulation contraire sera réputée non écrite."
90 French original: "manifestement excessive ou dérisoire".
91 *Droit civil des obligations*, Terré, Simler & Lequette, 11th Ed. 2013, at [627].

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