

## ENGINEERS & THE LAW

### Consequential Damages

#### Why contractual exclusion clauses aren't foolproof

By W.J. Kenny and E. Jane Sidnell

"There have been various cases on this subject, and in one a man was going to be married, and his horse cast a shoe, and the smith having injured the horse in putting it on, the man was late, and the lady refused to marry him; and it was held that the smith was liable for the damages resulting from the loss of the marriage...."<sup>1</sup>

This quotation from a British Columbia court back in June 2, 1868 raises a number of questions, but the only one that this article will deal with is: What are consequential damages?

If your office were to burn down, there would be direct damages in relation to the loss of the building and the contents, but there would also be losses because temporarily the business would not be operating. In addition, you would probably incur ongoing overhead costs such as salaries, professional fees and office expenses even while the business is suspended.

Liability for such indirect losses is frequently excluded in contracts in the construction and engineering fields. If you are the party who cannot claim such consequential damages, you may be out-of-pocket a considerable sum that cannot be recovered. On the other hand, if you are the party benefiting from a clause that excludes consequential damages, you are obtaining a potentially huge protection from loss.

Consider the situation where a gas plant is destroyed by fire due to a design error. If the contract excludes consequential damages, then the person who made the design error may be liable for the loss of the plant. But is that person protected from a claim for the owner's loss of production from the gas plant while it is being reconstructed? Who bears the loss relating to the owner's overhead during that reconstruction period? What if the owner has further losses because it can no longer fulfil contracts for the supply of gas? Who bears that loss?

In 1997, the Alberta Court of Appeal court considered the following exclusion clause in a case relating to consequential damages, known as *Syncrude Canada Ltd. v. Babcock & Wilcox Canada Ltd.*:

"49 Consequential Damages: the Subcontractor will not be liable in any event for loss of anticipated profits, loss by reason of plant shutdown, non-operation or increased expense of operation of other equipment, or other consequential loss or damage of any nature arising from any cause whatever."

The case dealt with the damages that Syncrude could recover as a result of three defective boilers designed and built by Babcock & Wilcox. The trial judge awarded \$6 million in relation to the cost of repairing the boilers. However, the trial judge also awarded \$4 million in relation to the extra cost of energy as a result of the boilers being inefficient, from the time of the defect becoming apparent to the date by which Syncrude could have had the boilers repaired. Babcock & Wilcox appealed this decision and argued that the \$4 million portion of the award to Syncrude was covered by the exclusion clause

above and not recoverable by Syncrude.

The Court of Appeal did not agree with the Babcock and Wilcox argument that anything beyond the direct cost of repairing the boilers was excluded by clause 49. In upholding the award to Syncrude, the court stated that damages should be calculated based on the difference in value between what was contracted for, and what was delivered. In making this calculation, the capitalized value of the extra energy expenses was taken into account. The court found that the additional cost of energy because the defective boilers were inefficient was not eligible as "consequential" to the damage incurred and therefore was not excluded by clause 49.

The English Court of Appeal also considered consequential damages in a 1998 case, *Deepak Fertilisers and Petrochemical Corporation v. Davy McKee* (London). The case arose after an explosion destroyed a low pressure methanol plant. The process was licensed to the owner by the designer of the plant, who also constructed the plant through a subsidiary (referred to as the "design-builder"). The limitation of liability clause in the contract between the owner and the design-builder provided as follows:

"... and in no event shall [the design-builder] by reason of its performance or obligation under this contract be liable ... for loss [of] anticipated profits, catalyst, raw-material and products or for indirect or consequential damages."

As a result of the plant exploding, the owner suffered a number of losses in addition to having to pay to re-construct the plant. In particular, the owner claimed for fixed costs and overheads incurred during the period from the explosion to the resumption of commercial production (referred to as "overheads"). The owner also claimed for increased costs due to the re-constructed plant requiring more catalyst to operate than the original plant configuration (referred to as "catalyst cost").

The English Court of Appeal concluded that losses which "'clock up at once' (namely the cost of idle men and plant etc.)" are direct losses and not consequential losses. Since the overheads started to accrue as soon as the explosion occurred, they were considered direct damages and not consequential losses. In analysing the limitation of liability clause, the court stated that "[w]asted overheads incurred during the reconstruction of the plant, as well as profits lost during that period, are no more remote as losses than the cost of reconstruction." The court concluded that the overheads were not consequential damages and so were not excluded from the claim.

Note, however, that at the same time, the limitation of liability clause did protect the design-builder from the claim for loss of profits because the clause specifically excludes "claims for loss of anticipated profits." Because the limitation of liability clause spelled out those losses in particular, the owner could not claim for lost profits from the design-builder.

As for the cost of additional catalyst, the court found this to be a valid claim for damages. On this point the court said: "The extra cost claimed is the cost which has now become necessary in order to ensure and enable the plant safely to produce methanol in those quantities which the plant was supposed to. In other words, we would hold that this extra cost is akin to any other cost (such as an additional piece of plant or part) which achieved the same result. This could not be categorized as an indirect or consequential loss or damage nor could its cost be categorized as constituting a loss of profit."

Consequential damages are not simply damages incurred beyond those that have directly affected the property. Consequential damages are those losses foreseeable with special knowledge. When negotiating a contract the parties should consider which damages they expect to be recoverable and those which will be excluded, or limited. Exclusion clauses must be drafted clearly as courts will only enforce the narrow

meaning of the words used to exclude or limit responsibility. Where the parties agree to exclude or limit damages for overheads, loss of profit, or additional costs to bring the project back to the level it was contracted to operate at (for instance the boiler specifications in the Syncrude case, or the use of catalyst in the English case), then those potential losses should be specifically and clearly excluded or limited by the terms of the contract. Relying on a general exclusion as to consequential damage will not afford protection against those kinds of losses.

The ACEC Prime Agreement between Client and Engineer contains a limitation of liability clause that specifically relates to consequential damages, in Schedule C:

"C.3 The Engineer's liability with respect to any claims arising out of this Agreement shall be absolutely limited to direct damages arising out of the Services, and the Engineer shall bear no liability whatsoever for any consequential loss, injury or damage incurred by the Client, including but not limited to claims for loss of profits and loss of markets."

Given the interpretation of direct damages and consequential damages in the two cases above, clause C.3 may not provide any more protection to the engineer than the clauses in those cases did.


Careful consideration should therefore be given to what the parties consider to be direct losses and consequential losses. If there are particular foreseeable losses or damages that are to be excluded by contract, then they should be identified in the contractual terms.

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1 Unidentified case quoted, with disapproval, by Willes J. in *British Columbia and Vancouver's Island Spar, Lumber and Saw Mill Co. Ltd. v. Nettleship* [1861-73] All E.R. Rep. 340 (C.P.)

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