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Insights

GLOBAL WATER ASSOCIATES: APPLYING HADLEY V BAXENDALE

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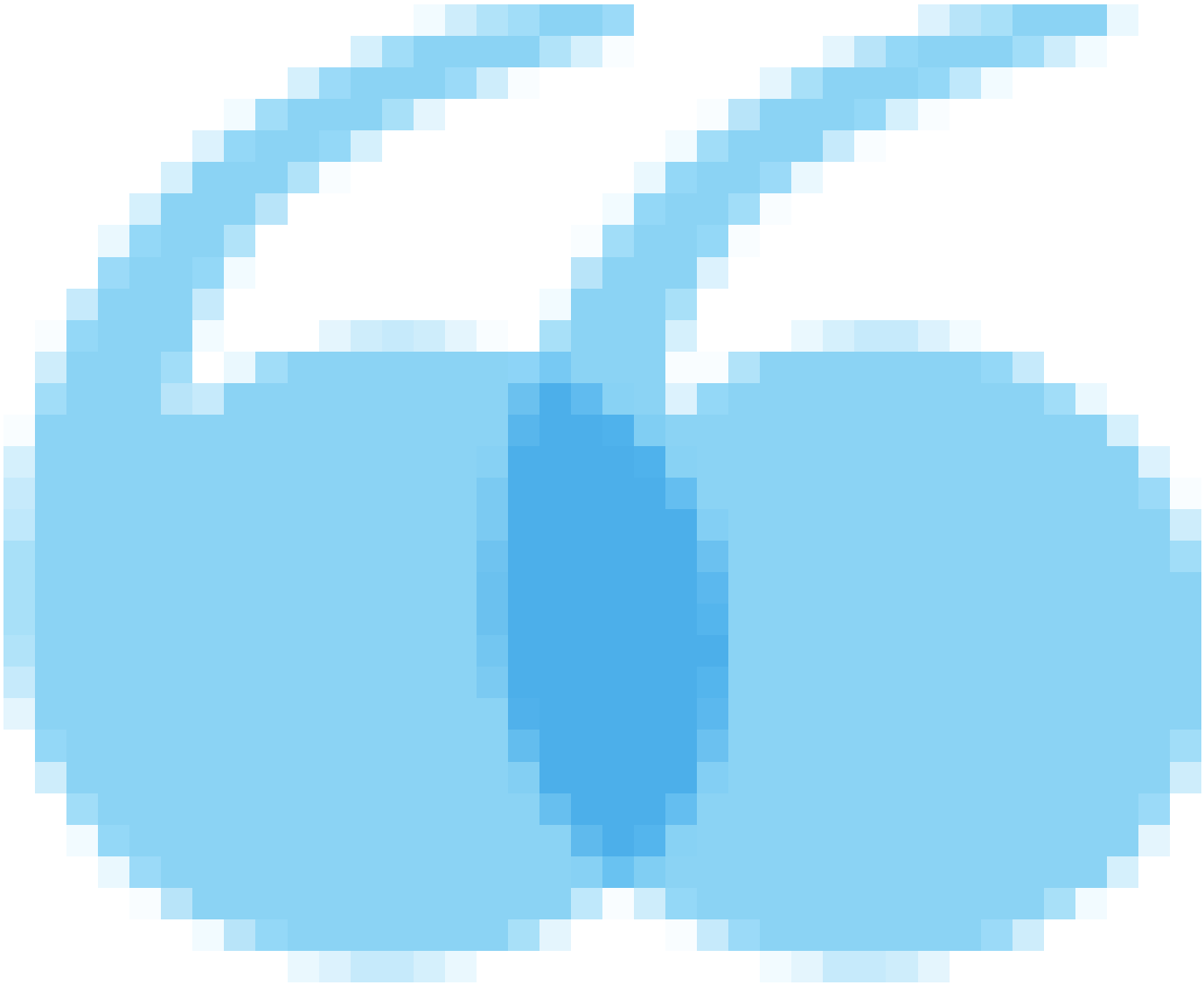
SUMMARY

From time to time, those seminal cases we all studied during the early parts of our career pop up in practice. We're all familiar with them: the snail in the bottle in **Donoghue v Stevenson**; the spurious sounding flu remedy in **Carlill v Carbolic Smoke Ball Co** — the list goes on.

Of these key cases, one that has us continually reaching for the textbooks and considering in increasingly varied circumstances is the Court of Exchequer's 1854 decision in **Hadley v Baxendale**. The scope of recoverability for **damages arising from a breach of contract** laid down in that case — or the test for "**remoteness**"— is well-known:



Now we think the proper rule in such a case as the present is this:—Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.

The proper application of the two limbs to commercial contracts has remained a hot topic ever since, with the Privy Council's decision in **Attorney General of the Virgin Islands v Global Water Associates Ltd** being the most recent addition to a long line of such cases.

In this case, the Privy Council upheld a contractor's claim for damages for breach of a construction contract that included the profits that the contractor would have made on both the design and construction phase of the project **and** its subsequent operation and maintenance under a separate agreement on the basis that the loss of profits under the separate contract fell within the second limb.

Identifying whether lost profits are recoverable is a confusing exercise at best. The simple limbs cited above in theory should lead to clear results, but the reality is that they have led to 170 years of uncertainty with cases turning on their facts. Therefore any judicial guidance on the operation of

the limbs is always welcome. This blog takes a closer look at this case and considers what we can learn from it.

The facts – a quick recap

In September 2006, the Government of the British Virgin Islands engaged Global Water Associates Ltd (GWA) under the following two contracts:

- a **Design and Build Agreement** (DBA) for GWA to design and build a water treatment plant; and
- a **Management, Operation and Maintenance Agreement** (MOMA) for GWA to manage, operate and maintain the plant.

The Government substantially breached the DBA by failing to deliver a prepared site to GWA, and the water treatment plant was not built. GWA terminated the DBA after issuing a notice to remedy, to which the Government did not respond, and pursued its claims in an arbitration. The dispute weaved its way up to the Privy Council for final determination.
GWA's two claims that were relevant to the appeal were:

- Breach of the DBA for failure to deliver the project site. The claim included amounts due under the DBA and for lost profits that would have been earned under the MOMA; and
- Breach of an **implied term** of the MOMA to the effect that the Government would perform its obligation under the DBA to provide a prepared site.

As the appeal was successful in relation to the first claim, the Privy Council did not consider the second.

The issues and findings

The primary question on appeal was whether the contractor's claims for lost profits under the MOMA were too remote?

The Privy Council held that the lost profits were not too remote. After summarising the relevant principles developed on the basis of *Hadley v Baxendale*, the key issue was whether GWA's inability to earn profits under the MOMA were in the reasonable contemplation of the **parties to the DBA** when they entered **that contract**. This was a question of fact. The following facts were determinative:

- The DBA and MOMA were entered into by the same parties on the same day, and related to the same project and site;
- The Government knew and intended that the parties' performance of their respective obligations under the DBA would lead to the commencement of the MOMA;
- The two contracts incorporated the same documents; and

- There was no express term in the DBA limiting the Government's liability for damages to the DBA only.

So, the lost profits under the MOMA were awardable for breach of the DBA because they fell within the second limb of the **Hadley v Baxendale** test – they were consequential losses, and therefore not too remote.

Loss of profits: which limb?

While this case essentially applies the existing law to the facts and does not develop the law in any significant way, I think it worth making a few observations about the Privy Council's finding that the lost profits were a form of consequential loss.

First, it is often assumed that lost profits sit within the first limb of **Hadley v Baxendale**, but this case is a reminder that this is not necessarily so. The nature of the lost profits is directly relevant to which limb of the test may apply. Lost profits that would have been earned as a result of the breached contract may well be direct losses. However, if the lost profits would have been earned under separate contracts, the relevant enquiry will more likely be whether the losses can be classified as consequential (see this case's discussion regarding the leading **Victoria Laundry** case on this point).

Secondly, unlike many contracts of this type, the DBA plainly did not **limit or exclude claims for consequential losses**. Had it included such a clause, the question of whether the lost profits were direct or consequential losses may have been far more contentious. Given the facts set out above and the clear interdependency between the two contracts, would it have been arguable that the losses suffered under the MOMA were in fact said to have arisen naturally and in the ordinary course of things? Most likely not, because while "the parties envisaged the completion of the DBA to lead seamlessly into the operation of the MOMA", the DBA did not contain a promise to commence the MOMA phase. Indeed, the issue in this case was whether the lost profits fell within the second limb, or were too remote. Nonetheless, it would have been interesting to see such arguments in this context, where the separation between the two contracts was only a matter of degree.

Flowing from that, then, a final takeaway is a reminder of the care that needs to be taken when **drafting limitation clauses** that exclude consequential losses. Steer away from using broad brush terms such as "consequential loss". Instead expressly state which losses you intend to exclude.

Final thoughts

Ultimately, while this case is a recent addition to the body of case law in this area, it wasn't an opportunity for the courts to consider some of the bigger questions on this topic. I'd keep those textbooks handy.

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