EXCLUSIONS OF CONSEQUENTIAL LOSS IN SHIPBUILDING CONTRACT WARRANTY CLAUSES

29 JUNE 2017 • ARTICLE

In *Star Polaris LLC v HHIC-PHIL Inc (1)*, the Commercial Court returned to the subject of shipbuilding contract warranty clauses and issued further guidance as to the proper interpretation of exclusions of consequential losses in that context. The Court concluded that the exclusion clause in question was effective to exclude liability for all financial loss caused by the defects to which the Builder's warranty applied over and above the cost of replacement and repair of physical damage. In reaching this conclusion, the Court declined to adopt the more restrictive interpretation of consequential loss regularly adopted in other cases, albeit in different contexts.

BACKGROUND

Prior to *Star Polaris*, a series of decisions had defined "consequential loss" when used in the context of a limitation of liability clause as covering only those losses that fell within the second limb of the rule in *Hadley v Baxendale*. That is a reference back to a 19th century case, which distinguished between two different types of loss in a breach of contract case:

1. direct losses, being those losses arising naturally (i.e. in the usual course of things) from the breach of contract or those losses that may be in the reasonable contemplation of the parties when the contract was made as the probable result of the breach (the so-called "first limb" losses); and
2. indirect or consequential losses, being losses resulting from special circumstances and that will be recoverable only if the parties knew of those circumstances ("second limb" losses).

Ship-owners that discovered a defect in their newbuild vessel and suffered loss of earnings when dry-docking the vessel to undertake repairs would therefore claim that their loss of earnings was a loss arising naturally from the shipbuilder's breach of contract (i.e. a first limb loss) and not therefore barred by an exclusion of consequential loss that applied to second limb losses only. This legalistic approach to the definition of consequential loss almost led to outcomes in some cases that will have been at odds with what non-lawyers who negotiated the original contracts might have expected.

In *Transocean Drilling UK Ltd v Providence Resources Plc (2)*, the Court of Appeal had observed that courts may now be more willing to recognise that words take their meaning from their particular context. The same words may therefore mean different things when used in different documents. This is the context in which *Star Polaris* was decided.

THE FACTS

In *Star Polaris*, the claimant (the Buyer) had entered into a shipbuilding contract with the defendant (the Yard) for the construction of a bulk carrier (mv "STAR POLARIS"). More than six months after delivery, the vessel suffered engine damage and was towed to Korea for repairs.

THE AWARD

The Buyer commenced arbitration proceedings against the Yard, claiming that the engine failure was caused by the Yard's breaches of the shipbuilding contract and that it was therefore entitled to, among other items, the cost of the repairs to the vessel as well as towage fees, agency fees, survey fees, off-hire and off-hire bunkers caused by the engine failure. Further, at the arbitration hearing, the Buyer claimed the diminution in the value of the vessel.

The Yard argued that, under the Builder's warranty provisions in Article IX of the shipbuilding contract, it had provided a 12-month guarantee of material and workmanship, and that although it had certain positive obligations to remedy physical defects covered by the guarantee, it did not have any other liability after delivery of the vessel. Further Article IX(4)(a) of the shipbuilding contract expressly excluded liability for any "consequential or special losses, damages or expenses unless stated herein". Article IX was stated to replace and exclude all other obligations and liabilities of the Yard in respect of defects in the vessel, whether under the shipbuilding contract or otherwise.

The tribunal found that, in the context of Article IX of this shipbuilding contract, consequential or special losses had a wider meaning than under the second limb of *Hadley v Baxendale*, especially where the only positive obligations assumed by the Yard under the shipbuilding contract were the repair and replacement of defects and physical damage caused by such defects. Further, the shipbuilding contract differentiated between cost of repair or replacement and broader financial consequences incurred by the need for repair and replacement. In that context the word "consequential" had to mean that which follows as a result or consequence of physical damage, i.e. the additional financial loss other than the cost of repair or replacement.

THE APPEAL

The Buyer appealed to the Commercial Court on the two following questions of law:

- What was the correct construction of the phrase "consequential or special losses, damages or expenses" in Article IX(4)(a) of the shipbuilding In particular, did that phrase mean such losses or expenses as fall within the second limb of *Hadley v Baxendale* or, alternatively, did the phrase have a "cause and effect" meaning as held by the tribunal?
- If the tribunal was right as to the meaning of "consequential or special losses, damages or expenses", on a proper construction of Article IX(4)(a), did diminution of value constitute a "consequential or special loss"?

While there were no real issues between the parties on the principles of contractual construction, the parties emphasised different elements of those principles and the factual matrix. In particular, the Buyer submitted that the starting point for determining construction is the wording used by the parties, and that it would be presumed that the parties intended the words to have the meaning that has traditionally been ascribed to them – in this case meaning that "consequential loss" referred to losses under the second limb of *Hadley v Baxendale.* The Buyer further argued that the authorities in support of the established meaning of "consequential loss" included several Court of Appeal decisions and that it was therefore not open to the first-instance court to overrule these decisions. The Yard in turn submitted that the intended meaning of the actual wording of the shipbuilding contract was not the meaning of the wording in *Hadley v Baxendale* and therefore that the line of authorities were not relevant.

THE DECISION

Sir Jeremy Cooke (sitting as a High Court judge) held in favour of the Yard, and answered the two questions on appeal as follows:

- "Consequential or special losses, damages or expenses" had the wider meaning of financial losses caused by guaranteed defects, above and beyond the cost of replacement and repair of physical damage. Importantly, this wording was not limited to losses, damages or expenses falling under the second limb of *Hadley v Baxendale*.
- Following on from the above, the claim for diminution of value was also a claim for "consequential or special loss". However, in line with the tribunal's decision in the arbitration, the judge held that the obligation on the Yard was only to replace or repair or bear the cost thereof, and a claim for diminution of value was therefore excluded.

COMMENTARY

Plainly, in light of the decision in *Star Polaris,* one should no longer simply assume that exclusions of consequential loss will be treated by the courts as referring to losses within the second limb of *Hadley v Baxendale*. That is now seen as too strict a rule. This does not, of course, mean that the wider interpretation of consequential loss adopted in *Star Polaris* will be automatically applied when the term is used in other clauses or other contracts. In fact, the lesson to be drawn from *Star Polaris*, once again, is that context is hugely important when engaging in any exercise of contractual interpretation.

Of fundamental importance to the outcome in *Star Polaris* was the Court's acceptance that the Builder's warranty in Article IX, when considered as a whole, constituted a complete code for the determination of liability for defects after delivery of the vessel to the Buyer from the Yard. This notion of the Builder's warranty as a complete code is widely acknowledged and Sir Jeremy Cooke's findings on this point echo views expressed by Mr Justice Thomas (as he then was) in *China Shipbuilding Corporation v Nippon Yusen Kabukishi Kaisha and Another (The Setu Maru) (3*).

Recognising that Article IX as a whole was intended to set out a comprehensive code in relation to liability for defects post-delivery, the scope of the Yard's liability could be seen as being framed both by the terms of Article IX(4), which excluded liability, and by the terms of Article IX(3), which set out the Yard's positive obligations in respect of repair and replacement. Article IX(4) made it clear that there was no liability above and beyond the express obligations undertaken by the Yard. The terms of the Builder's warranty did not cover financial losses consequent on physical damage and the Buyer could not point to an express provision that would give rise to a claim for financial loss, lost profit or diminution of value.

Although ceasing to interpret consequential loss rigidly as a reference to losses under the second limb of *Hadley v Baxendale* might be considered by some as introducing greater uncertainty into the exercise of interpreting contracts, many will no doubt welcome the fact that the Commercial Court has shown willingness to attribute to the term "consequential loss" a meaning that is much more closely aligned to what ordinary commercial men or women would expect.

It will be interesting to see how the courts apply this new approach to exclusions of consequential loss in other cases and whether they might also take a fresh look at the application of one or two other commonly cited, but not entirely uncontroversial, rules of contract interpretation.

1 [2016] EWHC 2941 (Comm)

2 [2016] EWCA Civ 372

3 [2000] 1 Lloyd's Rep. 367

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