Guaranteeing to remedy a defect

Andreas Dracoulis, at Haynes and Boone CDG, considers an important English High Court decision on contracts

An important decision of the High Court in London, *Star Polaris LLC v HHIC-Phil Inc (The Star Polaris)* [2017] 1 Lloyd's Rep 203, has confirmed the English courts' commitment to interpreting contractual provisions against the background of the contract as a whole – an approach that is to be welcomed by commercial parties choosing English law to govern their contracts. From a shipbuilding perspective, however, it does leave open for debate the interpretation of certain language commonly used in post-delivery warranty regimes.

Legal context

There is a long line of English court decisions which have determined that the phrase "consequential loss", when used in the context of an exclusion clause, means losses that do not arise naturally from a breach of contract but instead result from some special set of circumstances. Under English law such losses are only recoverable (if not excluded by the contract) if the other party knows of those circumstances. Lawyers refer to this type of loss as "second-limb" losses (the terminology arises from the late 19th-century decision in *Hadley v Baxendale* [1854] EWHC Exch J70).

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This can be contrasted with "direct" losses, which are those that arise naturally and which would have been in the parties' contemplation when the contract was made. Such losses are termed "first-limb" losses. Losses that do not fall within either the first or second limb are considered unforeseeable, or too remote, and not recoverable (regardless of any exclusion clause).

This approach has, however, come under criticism on the basis that the meaning given to "consequential loss" is not how most commercial parties would understand it. It is said that commercial parties would conceive "consequential loss" as everything beyond normal loss, normal loss being the loss that every claimant in the same situation would suffer. So for a ship repair dispute, normal loss would include the cost of repairing a defect because every claimant will suffer this loss; and "consequential loss" would include the losses for the period that the ship is off-hire as these would depend upon chartering arrangements specific to each claimant.

Consequential losses, when interpreted in this way, could therefore fall within either the first or second limb losses for the purposes of English law.

Difficulties arise where parties have used contradictory wording in the exclusion clause making it unclear if only second-limb losses are excluded, or whether some measure of first-limb losses are also excluded.

Facts of the case

The case arose out of a shipbuilding contract between Star Polaris LLC, as buyer, and HHIC-Phil Inc, as builder, for the construction of a 180k dwt "Capesize" bulk carrier known as *Star Polaris*. The contract, which was a variant of the widely used standard form produced by the Shipbuilders' Association of Japan (or SAJ), contained a detailed warranty regime applicable following delivery of the vessel. Under the warranty regime the builder guaranteed the vessel, for a period of 12 months, "against all defects which are due to defective materials, design error, construction miscalculation and/or poor workmanship". The builder also agreed to a positive obligation to remedy any defects against which the vessel was guaranteed. Critically the warranty regime then provided that the builder was to have no other liability after delivery and, further, excluded the builder from liability for "any consequential or special losses, damages or expenses unless otherwise stated herein".

The vessel was delivered to the buyer in November 2011, but soon after in June 2012 suffered a serious engine failure and was towed to a shipyard in South Korea for repairs at the buyer's cost. In arbitration proceedings the buyer sought to recover both the cost of the repairs and also other losses including its loss of income during the period of repairs and the diminished value of the vessel as a consequence of the repairs.

The tribunal's award

The arbitration tribunal concluded that there was a causative breach of the builder's warranty of quality (due to weld spatters in

the engine's pipework at delivery). Accordingly, but subject to an argument in mitigation that the damage had been exacerbated by the chief engineer's negligence, the builder was found liable for the cost of the repairs.

However, the tribunal concluded that the contract properly construed excluded liability for the buyer's financial losses. The tribunal determined that the word "consequential" in the contract was used by the parties in its "cause-and-effect" sense, ie it simply referred to losses which resulted from a breach by the builder of its warranty obligations (ie being the engine failure). Use of the phrase "consequential loss" did not therefore mean that only second-limb losses were excluded such that it was open to the buyer to recover (direct) first-limb losses. Given that the buyer's claims for loss of hire and diminution in value were consequential, in a cause-and-effect sense, on a true construction of the contract they were not recoverable. The buyer appealed this finding.

The court's decision

Key to the decision-making process of the tribunal was its finding that the warranty regime amounted to a complete code for the purposes of the builder's responsibilities post-delivery, and pursuant to which the only positive obligation assumed by the builder was (essentially) the repair of defects. As such the word "consequential" had to mean that which followed as a consequence of physical damage, namely the additional financial loss other than the cost of repair.

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The court agreed with the tribunal concluding that there was no express provision that the buyer could point to in the warranty regime giving rise to an entitlement to claim for lost profit or diminution in value. Financial losses were not, in the court's view covered by the warranty regime. Thus in circumstances where there was no obligation on the builder above and beyond the positive obligation to repair defects, the phrase "consequential loss" must have been intended by the parties to have a wider meaning that was not restricted to second-limb losses. Therefore the relevant wording in the warranty regime, excluding the builder from liability for "any consequential or special losses, damages or expenses", meant that financial losses caused by guaranteed defects were excluded. In the court's view the obligation to repair/replace was exhaustive and nothing else beyond that was recoverable.

Discussion

The approach of the court (and the tribunal) is entirely sensible and one that we would endorse. Shipbuilding contracts are regularly concluded on the basis that the builder's liability, following delivery, is restricted to the cost of repair or replacement of defects and nothing beyond; and looking at the overall warranty regime from a common sense commercial perspective that appears to have been the parties' intention. Against that background it would have been a peculiar decision if the court (and the tribunal) had strictly applied the English courts' approach to the interpretation of the phrase "consequential loss". In deciding the case in this way, the court (and the tribunal) adopted what lawyers sometimes refer to as a "purposive" approach to contract interpretation – the relevant exclusionary wording was not interpreted in isolation but in the context of the contract as a whole and, no doubt, against the commercial background in which shipbuilding contracts are concluded. This will be welcomed by commercial parties from a variety of industry backgrounds who elect to use English law to govern their contracts.

There is, however, an aspect of the decision that does merit further discussion. As indicated above, the key finding underpinning both the court's and tribunal's findings was that the builder's responsibilities under the warranty regime were restricted to the repair of defects. However the initial operative wording of the warranty regime, which states that "the builder ... guarantees the vessel ... against all defects", arguably provides for a wider responsibility. In its judgment, the court indicated that this initial wording did not describe the actual liability of the builder; in particular what it was that the builder was undertaking to do. The court was of the view that the actual liability was defined in the later wording setting out the builder's positive obligation to repair defects. That could, however, be seen as a slightly curious approach, because it would surely be open to a builder to "guarantee" a vessel against defects for a limited period of time without anything further being said but thereby still generating an enforceable contractual obligation. It may well have been that the court had the standard SAJ wording in mind, which provides for an undertaking to remedy defects, but that is different to the present contract where the builder "guarantees" the vessel against all defects.

If it is accepted that the "guarantee" is in itself an enforceable obligation then that is, absent exclusionary wording, an express provision potentially generating a claim for financial losses beyond the cost of repairs. Given also an absence in the contract of the usual industry wording both excluding claims for loss of hire and expressly limiting the builder's liability to the cost of repairs, and taking into account the English law interpretation of the phrase "consequential loss", then the contractual background against which the exclusionary words were interpreted is altered. Against this background, and based on what we know from the judgment, the buyer may potentially have missed an opportunity to present its case slightly differently. Had it done so, and had the appeal taken place before a judge more willing to apply the phrase "consequential loss" strictly in accordance with previous authority, then it is possible to envisage a different outcome. ***MRI***

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