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Prevention is better than cure: remoteness of damages revisited

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Introduction

In *Attorney General of the Virgin Islands* v *Global Water Associates Ltd (British Virgin Islands)* [2020] UKPC 18, the Privy Council held that a contractor's claim for damages for breach of a construction contract could include the profit it would have made if it had completed the facility and operated it under a related operation and maintenance agreement. The judgment is of practical interest as it applies existing principles of remoteness of damages in the context of major engineering projects.

Background

The Government of the British Virgin Islands entered into two contracts with Global Water Associates Ltd ("**GWA**") in September 2006 relating to a proposed water reclamation treatment plant. The first contract was a Design Build Agreement under which GWA agreed to design and build a 250,000 US gallons per day water reclamation treatment plant. The second contract was a Management, Operation and Maintenance Agreement ("**MOMA**") by which the Government engaged GWA to manage, operate and maintain that plant. Clause 3.1 of the MOMA provided that the agreement was for a period of 12 years from the commencement date, which was the date the plant would first be capable of achieving the level of water processing for which the Government contracted in the DBA.

The dispute between the parties arose out of a breach of contract by the Government. The Government failed to provide a suitably prepared project site to enable the construction and installation of the plant, as it was required to do under the DBA. Absent a site, the plant was unsurprisingly never built. As a result of this breach of the DBA, GWA was not able to earn the profits which it would have made from managing, operating and maintaining the plant during the 12-year term of the MOMA.

GWA properly terminated the DBA after giving the Government contractual notice to remedy its default, to which the Government failed to respond. Having done that, GWA referred its claim for damages for breach of the DBA to arbitration. The damages claimed included the lost profits GWA would have earned under the GWA.

Initial legal proceedings

Although the arbitrators found that the Government had breached the DBA in failing to provide a prepared site, they held that the profits which would have been earned under the MOMA were too remote to be recoverable. The arbitration agreement between GWA and the Government did not exclude the right to appeal an arbitration award on a point of law. GWA therefore appealed to the High Court of the British Virgin Islands, arguing that the arbitrators had made an error of law on the face of the award. Mr Justice Leon agreed with GWA, holding that damages for breach of the DBA were not confined to sums payable for the performance of works under the DBA, as the arbitrators had found, but extended to the profits which GWA would have earned under the MOMA.

The Government appealed to the Court of Appeal, which swiftly reversed the decision of the High Court. The Court of Appeal held that the natural and direct consequence of a breach by the Government of the DBA was that GWA would lose such monies (if any) as it was entitled to receive under the MOMA. GWA sought to overturn this decision in the ultimate appellate court for the British Virgin Islands, the Privy Council.

Remoteness of lost profit under a second contract

Lord Hodge, giving the sole judgment of the Privy Council, began his analysis by noting the strong connection between many of the terms in the DBA and MOMA. In particular, the definition of "*Commencement Date*" was identical in both contracts, as follows:

> "'*Commencement Date' means the date on which the Treatment Plant is first capable of processing 250,000 US gallons per day of Influent for transfer to the Effluent Transfer Point, such date to be agreed in writing between the Government and the Company and shall become an integral part of this Agreement.*"

It was clear from the DBA that the intention of the parties was for GWA to issue a 'Commencement Notice' following substantial completion of the plant. Once that notice had been served, the parties' obligations under the MOMA would take effect. That was apparent from Clause 9 of the DBA, which stated:

> "*When the Company* [GWA] *has completed the installation of the Treatment Plant, including the testing and commissioning thereof, such that it may be used for the purposes for which it is intended ('Substantial Completion') the Government shall issue a Taking over Certificate transferring ownership of the Treatment Plant to the Government. Thereafter, the Company shall issue a 'Commencement Notice' no later than ten days after receipt of the Taking Over Certificate, indicating the commencement of the management, operation and maintenance phase of the Treatment Plant.*"

Having set out how the contracts were intrinsically linked, Lord Hodge continued by setting out the principles of remoteness of damages under English law. This area of the law is often described as 'well-known', but let us remind ourselves of what we already know.

Lord Hodge began with the classic case of *Hadley* v *Baxendale* (1854) 9 Exch 341, in which the owners of a flour mill in Gloucestershire sent a broken iron shaft of the mill to engineers in Greenwich for use as a template in the manufacture of a new shaft. The defendants, who transported the shaft, knew, at the time when the contract of carriage was made, that they were transporting a broken shaft and that their customers were the owners of a mill. The delivery of the shaft to the engineers was delayed and the mill owners were not able to operate their mill until they received a new shaft. They claimed as damages for breach of contract the losses which they suffered as a result of the stoppage of their mill during the period of delay.

Baron Alderson gave the judgment of the court, holding that the claim for loss of profits was too remote because the circumstances that the shaft was being transported to be a model for the manufacture of a new shaft, and that the mill could not operate until the new shaft was delivered, had not been communicated to the carriers. He famously stated the principle in the following terms:

> "*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, ie, 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.*"

These propositions became known as the first and second limbs of the test for remoteness of damages. It was the second limb that was relevant to the current case, namely whether GWA's lost profits from the MOMA could

be said to have reasonably been in the contemplation of both parties as arising out of a breach of the DBA. Baron Alderson gave further guidance on when the second limb would be satisfied. He held:

> "*Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.*"

In other words, the more that the parties know about the circumstances which might arise from a breach of contract, the more likely that the parties will be liable for damages arising out of a breach of contract relating to those circumstances.

Lord Hodge also considered the decision of *Victoria Laundry (Windsor) Ltd* v *Newman Industries Ltd* [1949] 2 KB 528. In that case, launderers and dyers who wished to extend their business by taking on profitable dyeing contracts purchased a large second-hand boiler from the defendants, who were engineers, with an agreed date of delivery. At the time of the contract, the defendants knew that the purchasers were launderers and dyers and that they wanted the boiler for use in their business. In the negotiations for the purchase, the purchasers had explained in a letter that they intended to put the boiler into use "… *in the shortest possible space of time*".

When third parties, under a contract with the defendants, were dismantling the boiler for transportation, it fell on its side and was damaged. The purchasers refused to accept the damaged boiler and took delivery of it only after the defendants had arranged for its repair, which involved a delay of five months. The purchasers then claimed damages for breach of contract, including for loss of profits during the period of delay. Their claim included the loss of profits on particularly profitable dyeing contracts which the purchasers had wished to take on, the existence and details of which had not been communicated to the sellers.

The Court of Appeal held that the defendant only had to compensate for the ordinary loss of profits from the operation of the mill, not the extraordinary loss of profits from the dyeing contracts. The losses from the anticipated lucrative dyeing contracts were distinguished as a different type of loss which would only be recoverable if the defendant had sufficient knowledge of them to make it reasonable to attribute to him acceptance of liability for such losses.

Hadley v *Baxendale* and *Victoria Laundry* v *Newman* are venerable decisions that may be familiar to anyone who attended contract law lectures. More recently, the House of Lords in *Transfield Shipping Inc* v *Mercator Shipping Inc (The Achilleas)* [2008] UKHL 48 introduced the notion of 'assumption of responsibility' into the test of remoteness. Their Lordships noted that the true task of the court was to construe the contract in light of all the circumstances, to determine the scope of the defendant's implied assumption of responsibility for damages in the event of a breach. On that refined approach, the propositions in *Hadley* v *Baxendale* are still relevant, since it will often be the case that losses which the parties had reasonably contemplated were the kind of losses for which they would assume responsibility (absent an express term in the contract excluding liability). However, sometimes, even losses that are reasonably foreseeable may not be recoverable because they are, in the particular facts of the case, too remote. For example, losses which are, strictly speaking, within the contemplation of the parties might be so unpredictable in their amounts that the defendant will be found not to have assumed responsibility for that type of loss.

In *John Grimes Partnership Ltd* v *Gubbins* [2013] EWCA Civ 37, the Court of Appeal succinctly described the refined test as follows:

> "*Normally, there is an implied term accepting responsibility for the types of losses which can reasonably be foreseen at the time of contract to be not unlikely to result if the contract is broken. But, if there is evidence in a particular case that the nature of the contract and the commercial background, or indeed any other relevant special circumstances, render that implied assumption of responsibility inappropriate for a particular type of loss, then the contract-breaker escapes liability.*"

It is generally accepted that the notion of 'assumption of responsibility' is now part and parcel of English law on remoteness of damages for breach of contract. Lord Hodge in *GWA* described *The Achilleas* as a case concerned with "… *the recoverability of damages caused by unusual volatility in the market or questions of market understanding …*", issues that did not arise in the case before the Privy. His Lordship appears to have concluded that it was therefore not necessary to consider the concept of an 'assumption of responsibility' – noting further that in *The Achilleas*:

> "*… Lord Hoffmann and Lord Hope of Craighead sought to bring into play the concept of assumption of responsibility as a further limitation on contractual damages.*"

This could be read as suggesting that *The Achilleas* did not authoritatively refine the test of remoteness, with only two of their Lordships 'seeking' to introduce the new concept. It is suggested, however, that Lord Hodge was not putting a gloss on *The Achilleas*, but instead was of the view that, on the facts, the defendants could not escape liability because they had not assumed responsibility.

After concluding his review of the authorities, Lord Hodge set out the following five principles which govern remoteness of damages under English law:

> *"First, in principle the purpose of damages for breach of contract is to put the party whose rights have been breached in the same position, so far as money can do so, as if his or her rights had been observed.*
>
> *Secondly, the party in a breach of contract is entitled to recover only such part of the loss actually resulting as was, at the time the contract was made, reasonably contemplated as liable to result from the breach. To be recoverable, the type of loss must have been reasonably contemplated as a serious possibility.*
>
> *Thirdly, what was reasonably contemplated depends upon the knowledge which the parties possessed at that time or, in any event, which the party, who later commits the breach, then possessed.*
>
> *Fourthly, the test to be applied is an objective one. One asks what the defendant must be taken to have had in his or her contemplation rather than only what he or she actually contemplated. In other words, one assumes that the defendant at the time the contract was made had thought about the consequences of its breach.*
>
> *Fifthly, the criterion for deciding what the defendant must be taken to have had in his or her contemplation as the result of a breach of their contract is a factual one."*

Applying these principles (which do not mention the assumption of responsibility) to the facts of the case, Lord Hodge concluded that it was clear that the losses resulting from an inability to earn profits under the MOMA were within the reasonable contemplation of the parties to the DBA when they entered into that contract.

These two contracts were made between the same parties on the same day and they both related to the same project on the same site, giving rise to special knowledge under the second limb of the rule in *Hadley* v *Baxendale*. Further, the Government, when it entered into the DBA, knew and intended that the performance of each party's obligations under the DBA would lead to the commencement of the MOMA. Clause 9 of the DBA (set out above) envisaged the commencement of the "… *management, operation and maintenance phase*" of the Plant once testing and commissioning under the DBA had been completed.

Lord Hodge stated that the arbitrators and the Court of Appeal had made an error by saying that it was a natural and direct consequence of a breach by the Government of the DBA that GWA would lose such monies (if any) as it was entitled to receive under the MOMA. That was the wrong approach as it had the effect of ignoring the second limb of the test in *Hadley* v *Baxendale*, namely to consider which losses were within the reasonable contemplation of the parties at the time the contract was made.

The court drew attention to the fact that there was no express term in the DBA which limited the Government's liability in damages to GWA's loss of earnings under the DBA and there was no finding by the arbitrators that such a term was to be implied into the DBA. The parties had therefore not addressed the issue in their contracts, such that the position under common law would take effect. The Privy Court allowed GWA's appeal and remitted the award to the arbitrators for the assessment of damages, which would include GWA's loss of profits under the MOMA.

The Privy Council also noted that the arbitrators had fallen into error in drawing an analogy with the decision of the Singapore Court of Appeal in *Burgundy Global Exploration Corpn* v *Transocean Offshore International Ventures Ltd* [2014] SGCA 24. Transocean and Burgundy had entered into a drilling contract, whereby Transocean would provide a rig and drilling services. They also signed an escrow agreement, which required Burgundy to make an initial deposit of monies that would become payable to Transocean if it performed the drilling contract into escrow. Burgundy failed to make the deposit. That breach of the escrow agreement gave Transocean a right to terminate the drilling contract, which it did. Transocean then sought to recover its lost profits under the drilling contract from Burgundy. The Singapore Court of Appeal rejected that claim, finding that Transocean's loss for a breach of the escrow agreement was limited to the loss of the security, and nothing more. The key distinction between that case and *GWA* was, however, that Transocean could have decided to proceed with the drilling contract but without the benefit of the security that it was meant to have under the separate escrow agreement, whereas GWA automatically lost the MOMA as a result of the Government's breach. GWA was unable to proceed with the MOMA as the plant could not be built.

Comment

The recoverability of loss of profit is a recurring issue in construction and engineering cases. There is no general rule as to whether loss of profit is recoverable or irrecoverable. Recoverability at common law is fact and context dependent. As this case demonstrates, what is key is understanding what the parties had in their contemplation at the time they entered into the particular contract. This decision also provides a useful reminder of the importance of drafting clear and complementary provisions within construction contracts and O&M contracts dealing with the full extent of the parties' liability in the event of termination of either contract, for whatever reason.

In particular, the dispute would not have arisen if the DBA had clearly defined the heads of loss for which each party was to be liable on termination. Alternatively, as is common, the parties could have drafted an exclusion of loss clause dealing with liability for loss of profits under each contract in the event of termination. Foresight and precision in the drafting of termination and limitation clauses can avoid such long-running legal battles as occurred on these facts.