

# QUICK LAW

## EXCLUSION OF LIABILITY FOR INDIRECT LOSSES

Most commercial contracts contain a clause limiting liability of the parties to particular kinds of losses. Based on UK or US precedents, these contracts may refer to “indirect” or “consequential” losses.

How much liability is actually excluded by these clauses will depend on the governing law of the contract. The concept of an “indirect” loss has different meanings in different Asian jurisdictions.

### HONG KONG

Hong Kong law defines indirect or consequential loss in a way that will be very familiar to UK, Australian and New Zealand lawyers.

Following the rule in *Hadley v Baxendale*, direct losses are those that naturally flow in the ordinary course of things. These are “objectively foreseeable.” “Indirect” or “consequential” losses are those that may have been contemplated by both parties at the time the contract, as the probable result of the breach of contract. These are losses which may have been subjectively foreseeable only by the parties concerned.

A clause which excludes “indirect” or “consequential” losses will exclude those which are specific to the contract concerned and which parties must have known would arise as a result of the breach. For the purposes of exclusion clauses, the difference between an “indirect” and a “consequential” loss is unlikely to be significant.

Under Hong Kong law, if the exclusion clause only seeks to exclude liability arising from indirect and consequential loss without specifying a particular category of loss, i.e. lost profits, whether such a

clause will be effective will depend on the facts of the case, in particular, whether such losses were objectively foreseeable or whether they were foreseeable only by the contracting parties.

### PRC

Indirect loss is not a legal term under PRC Civil law. ‘Indirect loss’ is a theoretical concept. However, indirect loss is indirectly considered in the PRC Civil law and the *Contract Law of the People’s Republic of China* (“*Contract Law*”) and *General Principles of the Civil Law of the People’s Republic of China* (“*GP Civil LAW*”).

Indirect loss is commonly regarded as unforeseeable loss and dependent on individual conditions of the wronged party. Therefore it is difficult to assess the extent the loss. Based upon PRC legal principles, indirect losses are those losses which do not flow directly and naturally from the breach or infringement act.

A clause which excludes “indirect” loss will exclude those losses that are not directly caused by violations of a legal or contractual obligation, are unforeseeable and have no direct causal relationship to the loss.

Under PRC law, the ascertainment of indirect loss is based on causal relationship and not upon the type of loss (such as loss of profit, legal fees and so on). Therefore, if the exclusion clause does not specifically mention loss of profits, it is arguable that lost profits can be recovered despite an exclusion of “indirect” loss. It will depend on the facts of the case whether the loss of profits flow directly and naturally from the breach or infringement act.

## JAPAN

Article 416 of the Civil Code allows recovery of damages to (i) those which would ordinarily arise from the non-performance of the obligation with reasonable causation; and (ii) damages which have arisen through special circumstances, if the parties had foreseen or could have foreseen such circumstances.

Under Japanese law, there is no definition of “direct damages” or “indirect damages”. Alternatively, damages are categorized as being “damages within reasonable causation” or “damages without reasonable causation”.

A clause that excludes “damages without reasonable causation” will exclude those losses which are specific to the contract concerned and which only the parties have foreseen or could have foreseen would arise as a result of the breach. If the exclusion clause does not specifically mention loss of profits, it is arguable that lost profits can be recovered despite an exclusion of “damages without reasonable causation”. It will depend on the facts of the case whether the loss of profits ordinarily arose from the non-performance of an obligation in the contract and whether they are “damages within reasonable causation”.

## SOME EXAMPLES

- An exclusion clause in a distribution agreement excludes liability for “indirect loss” (or “damages without reasonable causation” in Japan) but does not mention loss of profits. The distributor (defendant) has breached its obligations to meet certain sales targets.
  - Hong Kong: Lost profits will most likely be recovered but will depend on the circumstances of the case. Lost profits will be considered a direct loss as the parties should reasonably have contemplated certain sales volumes arising from the distribution arrangement and that profits would naturally be derived in the ordinary course of things in the course of their relationship.
- PRC: Lost profits will be recovered. If the “loss of profits” in distribution agreement is directly caused by the breach, the lost profits will be recovered. In this case, the distributor breaches its obligations and the loss of profits is directly caused by the breach.
- Japan: Lost profits will be recoverable. If the failure to meet sales targets amounts to a breach of the agreement the breach would ordinarily give rise to a loss of profits.
- An exclusion clause in an IP licence excludes liability for “indirect loss including loss of profits” (or “damages without reasonable causation including loss of profits” in Japan).
  - Hong Kong: The drafter has confused “lost profits” as always being part of “consequential loss”. With this drafting, it is debatable whether the lost profits which are direct losses (objectively foreseeable losses) may still be recovered. It will depend on the nature of the breach and whether those losses arose naturally in the ordinary course of things.
  - PRC: Under PRC law, the ascertainment of indirect loss is based on causal relationship and not upon the type of loss. However, if the agreement states clearly that “loss of profits” is excluded and “loss of profits” is defined in the agreement, the lost profits may not be recovered. In this case, if “loss of profits” is not defined in the agreement, it is debatable whether the lost profits will be recovered. It will depend on the explanation of the Court in accordance with parties’ intent.

- Japan: Lost profits may be recoverable, depending on the facts of the case if they are “damages within reasonable causation”. This will depend on the nature of the breach of the contract and whether the losses ordinarily arose from that breach.
- A software development and licence agreement excludes liability for “indirect loss and loss of profits” (or “damages without reasonable causation and loss of profits” in Japan).
- Hong Kong: Lost profits may not be recovered. The plaintiff is limited to direct losses such as costs of replacement software.
- PRC: Lost profits may not be recovered. In this case, the agreement states clearly that “loss of profits” should be excluded. In addition, this agreement distinguishes “loss of profits” from “indirect loss”, so lost profits may not be recovered.
- Japan: Lost profits may not be recovered and the plaintiff may only recover “damages within reasonable causation” such as costs of replacement software.

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