

Effective Exclusion Clauses

What is an exclusion clause?

An exclusion (sometimes called a limitation or exemption clause) clause is one which attempts to exclude or limit a party's liability, or to exclude or limit the other party's rights or remedies, for example:

- financial cap on overall liability and/or caps on different liabilities;
- setting fixed or "liquidated damages" or "service credits" payments;
- exclusion of specific heads of loss, such as loss of profits, revenue, anticipated savings, data, etc;
- exclusion of consequential or indirect losses;
- time bars on claims, both within and after the term of the agreement;
- exclusion of certain warranties, conditions or other terms implied by statute or otherwise, e.g. satisfactory quality and fitness for purpose etc;
- excluding liability due to force majeure, i.e. matters beyond one's reasonable control;
- exclusion of specific remedies, e.g. specific performance, set-off rights;
- conditions to specific remedies, e.g. return of defective goods to be prepaid;
- reverse indemnities, e.g. customer indemnifying supplier for liability beyond that expressly accepted by supplier;
- entire agreement clauses and non reliance upon prior representations.

It may also be helpful to clearly state that the supplier is not taking responsibility for particular activities, e.g. not being responsible for verifying a design of the purchaser or not being responsible for failings in third party networks. However, note that sometimes this sort of provision can be construed as an exclusion clause which is subject to the tests mentioned below.

Effectiveness

For an exclusion clause to be effective, it must pass at least these tests:

- it must have been incorporated into the agreement;
- its wording must cover the liability in question;
- it must not be prohibited by statute or other law – e.g. under the Unfair Contract Terms Act 1977 ("UCTA"), the Consumer Rights Act 2015 ("CRA") or the Consumer Protection Act 1987. Note that UCTA does not apply to some contracts e.g. certain international sales, insurance, intellectual property, securities and land contracts.

2.1 Incorporation

Particularly where the parties are dealing on unsigned business terms (e.g. order forms with standard terms and conditions on the reverse), there can be difficulty in deciding whether one party's terms are incorporated in the contract when it was actually formed. If not, any exclusion clauses in the terms will be ineffective. This can be a particular problem in so-called 'Battle of the Forms' situations, when a

supplier may find that the purchaser's terms apply - perhaps, if these were the last terms submitted before the contract was treated as formed. Also, even in a formal contract, exclusion clauses in the main body of the contract can be inadvertently overridden by specific provisions in the schedules which may be expressed to override the main body.

Therefore any exclusions should be brought to the attention of the other party before the contract is signed, and this will come under particular scrutiny in consumer contracts.

2.2 *Construing the clause*

There is a general judicial hostility to exclusion and limitation clauses. If there is any ambiguity in the wording of a such a clause, it will be construed against the party seeking to rely on it. The provision must be comprehensive so it is clear that it covers the liability. This can lead to lengthier clauses which may be sub-divided into a number of sub-clauses, so that, if one exclusion is held to be ineffective, there is another one that may work. Even so, some case law has suggested that it may not always be possible to strike out parts of an exclusion clause.

One must consider what the clause is attempting to cover. This involves a consideration of at least these areas:

2.2.1 How may the liability arise?

A supplier may want the clause to cover each of the following:

- a complete failure to perform;
- delay in performance;
- defective performance or supply of defective product.

It has been held that there is no reason why an exclusion clause cannot cover "fundamental breach" if it is drafted widely and clearly enough. However, the common law will not generally allow a clause to relieve a contractor from all liability or enable him to provide a completely different supply than that which is agreed in the agreement.

It may be effective to expressly exclude liability for wilful default (many breaches have an element of a knowingly deliberate act or omission) but not, for instance, acts which are malicious, fraudulent or in bad faith.

If you intend your limits on limit liability to apply to your own repudiatory breach (e.g. walking away from a loss making contract) you would need to ensure the wording very clearly covered this situation. It is unlikely that general words excluding liability for (e.g.) breach of contract will be construed as covering this. In a case where the exclusion was expressed to apply to loss however arising, in connection with or arising out of the supply, functioning or use of hardware, software or services, it was held that the clause only covered the defective supply - but not delay or failure to supply, since the clause did not expressly state that.

2.2.2 What type of legal action may arise?

A simple exclusion clause in a contract may be construed as only covering breach of contract, but normally a supplier will want to cover non contractual claims too, for example:

- negligence;
- misrepresentation;
- liability for breach of statutory duty.

There have been cases where general words, such as “actions or liability however caused”, without further elaboration, have been held to cover negligence, but it depends upon the context. It is therefore safer for suppliers to list all relevant causes of action they wish to exclude.

2.2.3 Excluding certain type of damage or loss

Suppliers may want to exclude certain types of loss altogether (rather than just include them in the financial cap). Such losses often include loss of anticipated savings, profit, revenue and data. However, suppliers need to be careful not to exclude all the customer’s potential heads of loss leaving the customer without any substantial remedy, as this is unlikely to be upheld by a court, if challenged. Suppliers should, therefore, consider accepting liability for certain loss or damage e.g. for the customer’s wasted costs or additional costs of obtaining replacements.

2.3 *Unlawful Exclusions or Limitations*

2.3.1 These include clauses which purport to limit liability:

- for death or personal injury caused by negligence;
- for fraud or fraudulent misrepresentation;
- for lack of clear title in a sale or hire purchase of goods;
- for non conformity with implied terms, e.g. of satisfactory quality of goods – where one party contracts in the course of a business and the customer is a “consumer” as defined in CRA.

2.3.2 Any clause will be assessed as a whole and may be judged in the light of how it may apply in all cases, not just the case in dispute. So, any attempt to exclude liability which is prohibited by law may not only fail to that particular extent but may put in jeopardy the exclusion in other instances. It is, therefore, generally advisable to state expressly that one is not excluding or limiting liability in the cases mentioned in paragraph 2.3.1 or otherwise not permitted by law.

2.3.3 There are also a range of situations under UCTA where validity of a particular exclusion or limitation depends upon the ‘reasonableness’ of the clause.

3 **The Reasonableness Test**

3.1 UCTA imposes a reasonableness test on many exclusion clauses, for example:

- those forming part of written “standard terms” of business;
- where the customer is a “consumer”;
- loss resulting from negligence;
- (non-fraudulent) misrepresentation; or
- breach of statutory implied terms, e.g. of satisfactory quality or fitness for purpose, in agreements between businesses.

3.2 What constitutes “standard terms” is not straightforward. It should apply to a set of terms all of which had been fixed by the supplier, but it has been found by the Court of Appeal to also apply to a single exclusion clause where the supplier’s standard terms were negotiated, but the exclusion clause remained unchanged.

3.3 To pass the reasonableness test, the clause must be fair and reasonable in the circumstances which were, or ought reasonably to have been, known to, or in the contemplation of, the parties on entry into the contract. There are many factors to be considered by the court including:

- the relative abilities of the parties to meet the loss or obtain insurance - and their actual cover;
- the extent to which the exclusions were made known (e.g. use of bold print);
- whether less severe exclusion terms were available if the customer had been prepared to pay a higher price for them.

4 **Financial Cap**

There is no general rule as to what level of financial cap will be effective. Some businesses seek to set the cap equal to the overall price of the supply. This has been accepted by the courts in some but not all cases. A supplier may consider setting the cap at a multiple of the price (e.g. 120%) and have different caps for different liabilities, e.g. a higher limit for liability arising from physical damage caused by the supplier’s own negligence, as the supplier’s insurance may cover this.

Any insurance policy must be carefully checked, however. For instance, a public liability policy may be expressed not to cover damage to property or persons where the damage is caused in connection with the insured’s supply of goods or services. A supplier should therefore consider if it requires product or professional indemnity insurance as well. This will often be subject to a much lower financial limit than a public liability policy.

Further, insurance cover will normally be limited to the damages payable under the general law and not at a higher level that could be payable under a contractual indemnity.

Other methods of achieving a financial cap can be used. In one case, the supplier gave a money-back option if the software failed acceptance tests. The court decided that, since the customer did not take up this option but allowed the supplier to attempt for over a year (unsuccessfully) to fix the software, the extensive exclusions of liability were effective and the customer was left without a remedy.

5 **“Consequential” loss**

Many supplier businesses have a policy that they will not accept liability for consequential or indirect losses. Case law shows that it can be difficult to know whether a loss is “consequential” (or indirect) or whether it will be treated as “direct”. Broadly “direct” losses are those arising naturally from the breach, which would be viewed as “not unlikely” to arise. As the courts often find losses to be direct rather than indirect, an exclusion of “consequential and indirect” losses can give a false sense of security. Therefore, it is usually better to exclude liability also for any specific categories of loss that you are not prepared to accept liability for, e.g. for loss of revenue or profits (whether direct or indirect) as well as all consequential and indirect losses.

Several cases have highlighted the need for care in drafting: often clauses contain language such as “the Supplier shall have no liability for consequential and indirect losses **including** loss of profits”. It has been decided that the use of the word “including” characterises the exclusion of loss of profits as only those of a consequential or indirect type. The clause did not therefore exclude loss of profits which were “direct”.

6 **Mutuality**

Applying the clauses to both parties can assist in justifying the supplier’s exclusion clauses, but care must be taken not to inadvertently restrict the supplier’s remedies, e.g. where mutual exclusion of liability for loss of revenue or profit could, in theory, exclude the supplier’s only possible claim for damages upon a wrongful early termination of the contract instigated by the customer.

7 **Employees/sub-contractors**

Companies, LLPs and other businesses, particularly those providing services rather than goods only, need to be aware that the customer may make an additional claim in negligence against not only the Supplier itself but also members, directors, employees or sub-contractors of the business who may have been negligent e.g. in making designs or giving advice. One can provide that they, in addition to the business itself, have the benefit of the exclusion clauses, and that the monetary cap applies to all claims in aggregate against the business and such others. Also, one can provide that the customer understands it is dealing only with the supplier, that the individuals have not assumed personal responsibility and that the customer accepts it shall not have any claim additionally against the supplier’s personnel. This device is commonly used by LLPs. The enforceability of these provisions will vary according to the circumstances.

8 **Indemnities**

If a contract contains exclusions of liability in favour of the supplier and indemnities from the supplier, a supplier should consider whether all or particular exclusion clauses apply to the indemnities and/or other payment obligations and if so specify this so the position is clear.

An indemnity may in some cases be construed as an exclusion clause and, therefore, subject to the above tests. Also, UCTA provides specifically that an indemnity given by a consumer will be subject to the reasonableness test.

9 **Consumers**

Businesses dealing with consumers need also to be aware of other legislative requirements that can affect their ability to limit or exclude liability, notably for contracts entered into after 1 October 2015 the Consumer Rights Act 2015 (CRA), including:

- contract terms must be transparent and “fair” or otherwise will be unenforceable under CRA where the consumer is an individual acting for purposes that are wholly or mainly outside that individual’s trade, business, craft or profession;

- a contractual term not individually negotiated will be regarded under CRA as not fair and therefore not binding on the consumer, if it causes a significant imbalance between the parties' rights to the detriment of the individual consumer;
- the Consumer Protection from Unfair Trading Regulations 2008 make it a criminal offence to undertake an "unfair commercial practice". Including unenforceable terms in sales terms may amount to such a practice – so care is required.

10 Conclusion

When things go wrong, it is important to be able to rely on your exclusion clauses. When these clauses are challenged it can cost suppliers millions of pounds. Although it is impossible to predict a court's decision in any particular case, it is clear that certainly in business to business contracts, suppliers can substantially limit their liability through carefully drafted exclusion clauses that are not too wide or ambitious.

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