

# THE UNCERTAIN CONSEQUENCES OF WAIVING CONSEQUENTIAL DAMAGES\*

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*You keep using that word. I do not think it means what you think it means.*

Inigo Montoya, *The Princess Bride*

*Exclusion and limitation of liability clauses are almost ubiquitous in commercial contracts. Deal lawyers often use these clauses to mitigate transactional risks by excluding or limiting recovery for certain categories of damages such as consequential, indirect, and incidental damages as well as lost profits or revenue. While these terms are commonly used in the Canadian mergers and acquisitions context, the protection they offer is unclear and courts' interpretations do not always align with deal lawyers' assumptions. This article examines the difficulties involved in using these clauses to allocate risks between buyers and sellers, focusing especially on the uncertainties associated with consequential damages and lost profits. The article begins by discussing the interpretation of exclusion and limitations clauses and the principles governing damages. Next, the article examines the different definitions that courts and commentators have applied to consequential damages, other related terms, and the uncertainty in excluding lost profits that emerge from the case law. The authors ultimately conclude that there is no clear rule in Canadian contract law that deal lawyers can use to predict whether a particular loss is consequential or where lost profits fall in relation to the various categories. Therefore, lawyers cannot rely on boilerplate clauses or even past judicial interpretations to exclude or limit recovery for losses that they think are encompassed by these terms. Instead, they must carefully draft these clauses to address the parties' particular circumstances and identify the restricted losses as specifically as possible to provide the most reliable protection.*

## I. INTRODUCTION

Every merger or acquisition has risks. One of the most significant risks for either party is the risk that a breach of the purchase agreement will lead the buyer to receive less than it bargained to receive, or to lose significant revenue and profits, over an indeterminate period. Deal lawyers use various mechanisms to manage such risk and to protect the buyer's expectations, but one of the most widely used is also arguably one of the least understood.

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Exclusion or limitation of liability clauses are nearly universal in agreements for the sale of a business, which will generally address transactional risks by limiting the kinds of damages for which the parties will be liable if a factual statement contained in the agreement is wrong (a misrepresentation) or a party fails to comply with a covenant in the agreement. This often includes limiting recovery by excluding “consequential damages” or other seemingly related categories such as “lost profits”. But what do these terms actually mean and how are they related? When one looks at how such clauses are interpreted and applied by courts, it is clear that they do not always mean what deal lawyers think they mean.

This article focuses on consequential damages and the difficulties in dealing with exposure to damages for lost profits. While many deal lawyers may consider lost profits to be a form of consequential damages, Canadian courts do not necessarily treat lost profits (or lost revenue or wasted overhead) this way. There are a number of reasons for this mismatch. Notably, when a contract is breached, the plaintiff does not claim damages such as “all direct damages” or all “consequential damages”. Rather, the plaintiff will claim (and be required to prove) specific kinds of losses, such as the costs to repair or replace defective equipment, lost revenues, lost profits, wasted overhead, wasted raw materials, etc. However, these categories do not always line up predictably with the language used in contractual indemnities and exclusion clauses or with the legal categories of recoverable losses discussed in the case law and commentary. In fact, texts discussing the recovery of damages do not even address contractual damages from the perspective of direct damages and consequential damages. Rather, they commonly do so in relation to: (i) particular contractual breaches, such as the failure to deliver goods, delivery of defective goods, or breach of a representation or warranty on the performance of assets; and (ii) particular kinds of loss suffered, such as damage to property, harm to economic interests, loss of services, and lost profits on sales to third parties.<sup>1</sup>

This is not because courts apply phrases such as “consequential damages” or often-used terms for other kinds of damages inconsistently. For the most part, Canadian courts have taken a consistent approach to determining whether a plaintiff’s claim for a particular category of loss is recoverable as direct damages or has been excluded as consequential damages. The problem is that the approach taken by the courts does not let deal lawyers easily predict whether a particular kind of loss will always be seen as direct or consequential damages.

While much of the following discussion will deal with the confusion surrounding the expression “consequential damages” in protecting sellers from the risk of liability for lost profits, revenue and business opportunities, it will also touch on the meaning of other kinds of damages that sellers often attempt to exclude that may also be misunderstood. These include “indirect”, “incidental” and “special” damages.

This article will attempt to shed some light on the Canadian treatment of limitations of liability as well as clauses which waive or exclude liability for certain types of damages. In doing so, we hope to better equip deal lawyers to manage the specific risks their clients face in the context of their particular businesses and in specific transactions. While most of the available case law considers such clauses in the context of contracts for the sale of goods or services, limitation of liability and exclusion clauses are also an integral part of most share and asset purchase agreements

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<sup>1</sup> See, e.g., Stephen M. Waddams, *The Law of Damages*, 5th ed. (Toronto: Thompson Reuters, 2012) (looseleaf rev. 2018); Jamie Cassels and Elizabeth Adjin-Tettey, *Remedies: The Law of Damages*, 3rd ed. (Toronto: Irwin Law, 2014).

for the acquisition of a business. It does not appear that a Canadian court has addressed the effect of a contractual consequential damages exclusion on a claim for lost profits or diminution in revenues in this context. Our discussion, therefore, will necessarily be based on sales and service agreements, but we hope our conclusions will have equal application in the merger and acquisition context.

## II. INTERPRETIVE AND ANALYTICAL FRAMEWORK

While this article focuses on damages, the discussion remains fundamentally an exercise in contractual interpretation and takes place in a legal framework established by the Supreme Court of Canada and other appellate courts. It is important at the outset to consider this framework.

Contract law embodies many concepts. It is the means by which individuals freely engage in the exchange of ideas, money, property, or other things of value. Contracts also serve as a means to facilitate commercial activity. Contract law is said to protect the reasonable expectations of the parties.<sup>2</sup> Canadian contract law is anchored by an “organizing principle of good faith” that requires parties to “perform their contractual duties honestly and reasonably and not capriciously or arbitrarily”.<sup>3</sup> What this actually means in any given instance will depend on the nature of the contract and the obligations assumed. At a minimum, however, Canadian common law now requires contracting parties to have “appropriate regard” for the counterparty’s interests and to not act in bad faith, but to be honest, candid and forthright and to reasonably perform their respective obligations.<sup>4</sup>

Contract law also creates predictability in how bargains will be enforced by resort to the objectively determined intentions of the parties. Under modern jurisprudence, contracts are no longer interpreted according to technical rules of construction, but in “a practical common sense approach”, with a stated goal of giving effect to the objectively determined intentions of the parties.<sup>5</sup> Limitation of liability and exclusion of liability clauses accordingly will be enforced by Canadian courts if the clause applies to the circumstances in which the losses are claimed.<sup>6</sup> This requires the court to interpret the clause using the ordinary interpretive principles that apply to any commercial contract and to avoid an openly technical analysis. This, however, is not as straightforward an exercise as appellate courts may suggest.

A court’s primary objective is to give effect to the objectively determined intentions of the parties at the time the contract was made. In modern jurisprudence, technical interpretation rules have given way to a practical, common sense approach where the court will:

- Analyze the surrounding circumstances (the factual matrix), which includes the purpose of the agreement and the nature of the relationship created by the contract<sup>7</sup>

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<sup>2</sup> See Angela Swan and Jacob Adamski, *Canadian Contract Law*, 4th ed. (Toronto: LexisNexis, 2018), at pp. 3-5, 673-674 and 685. As Swan notes, the role of contract law in protecting the reasonable intentions of the parties to the bargain is not universally accepted. She rejects the long-standing Anglo-Canadian focus on the intentions of the parties (as objectively determined) as the sole guiding approach to contracts. As she notes, however, the outward or objective communications of the parties permits the court to have regard to the *reasonable* expectations (importing an objective approach to the facts, actions and words used by the parties) created in one party by the actions or communications of the other: see *ibid.*, at pp. 676 and 685.

<sup>3</sup> *Bhasin v. Hrynew*, 2014 SCC 71 (S.C.C.), at para. 63.

<sup>4</sup> *Bhasin v. Hrynew*, *supra*, footnote 3, at para. 65.

<sup>5</sup> *Creston Moly Corp. v. Sattva Capital Corp.*, 2014 SCC 53 (S.C.C.), at para. 47.

<sup>6</sup> *Tercon Contractors Ltd. v. British Columbia (Minister of Transportation & Highways)*, 2010 SCC 4 (S.C.C.), at para. 122.

<sup>7</sup> *Sattva*, *supra*, footnote 5, at para. 48.

and a consideration of the circumstances which were known or ought to have been reasonably known by the parties when they entered into the agreement;<sup>8</sup>

- Look to the common and ordinary meaning of the words chosen by the parties within the factual matrix, presuming the parties meant what they said, while recognizing that the meaning of the words in the agreement may be derived from the context;<sup>9</sup>
- Consider the words of one provision in harmony with the rest of the agreement, in light of the purpose of the agreement, and in a way that gives meaning to all of its terms and avoids an interpretation that makes other words, sentences or clauses superfluous, meaningless or ineffective. This means that limitation and exclusion clauses cannot be read disjunctively, but must be interpreted together with other limitations, exclusions and any warranty provisions; and<sup>10</sup>
- When all else fails, adopt an interpretation that is consistent with sound commercial principles and good business sense in order to avoid a commercially absurd result.

The court cannot use the factual matrix to rewrite the contract with the benefit of hindsight. The surrounding circumstances can only be used as evidence of the parties' mutual and objective intentions, which they are presumed to have expressed by the words they used.<sup>11</sup> Thus, when a court interprets and applies an exclusion or limitation clause, its focus will be on whether the clause applies to the circumstances, not whether the parties should have allocated their respective risks differently.

If the limitation or exclusion clause does not apply, the court's inquiry ends and the non-breaching party will be entitled to damages for all of its recoverable losses. If the non-breaching party's losses do fall within the kinds of losses or damages the parties intended to exclude, then the court has no discretion to refuse to enforce the limitation or exclusion clause unless: (i) the clause was unconscionable at the time the contract was formed;<sup>12</sup> or (ii) its enforcement would be contrary to public policy.<sup>13</sup> In the context of a commercial agreement negotiated between two sophisticated parties, it would be rare for a court to conclude that either unconscionability or public policy preclude holding the parties to their bargain. Rather, the key question for the court will be whether the exclusion or limitation clause applies at all.

### III. GENERAL PRINCIPLES GOVERNING THE RECOVERY OF DAMAGES

Before examining this subject more fully, however, we will revisit a dispute that centred on a flour mill located in Gloucester, England in the nineteenth century. Hadley operated a mill and used a steam engine to grind wheat. The steam engine broke a crankshaft, shutting down the

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<sup>8</sup> *Dumbrell v. Regional Group of Cos.*, 2007 ONCA 59 (Ont. C.A.), at para. 53.

<sup>9</sup> *Ventas Inc. v. Sunrise Senior Living Real Estate Investment Trust*, 2007 ONCA.

<sup>10</sup> *Ventas*, supra, footnote 9, at para. 24; *Tercon*, supra, footnote 6, at para. 64; *Richcraft Homes Ltd. v. Urbandale Corp.*, 2016 ONCA 622 (Ont. C.A.), at para. 59 ("it is an extricable error of law to read a provision of a contract in isolation rather than construe the contract as a whole"); *New Brunswick Power Corp. v. Westinghouse Canada Inc.*, 2008 NBCA 70 (N.B. C.A.), at para. 19.

<sup>11</sup> *Sattva*, supra, footnote 5, at para. 57.

<sup>12</sup> To be unconscionable, there must be: (i) a pronounced inequality in bargaining power; (ii) a substantially improvident or unfair bargain; and (iii) one party who knowingly took advantage of the vulnerability of the other: see *Allarco Entertainment 2008 Inc. v. Rogers Communications Inc.*, 2011 ONSC 5623 (Ont. S.C.J.), at para. 176.

<sup>13</sup> *Tercon*, supra, footnote 6, at para. 123.

mill. Hadley asked W. Joyce & Co. in Greenwich to manufacture a new crankshaft. W. Joyce & Co. asked Hadley to send it the broken shaft so that it could be sure that the new crankshaft would fit. Hadley hired Baxendale to deliver the broken crankshaft to W. Joyce & Co. The carrier agreed to deliver it the next day but it actually took five days to make the delivery. Hadley sued Baxendale for breach of contract, and claimed as his loss the profits he would have made during the five-day delay.

When this dispute reached England's Exchequer Court, Baron Alderson concluded that Hadley could not recover damages for the mill's lost profits. In explaining why, he set out one of the still fundamental principles of English, Canadian and United States contract law:<sup>14</sup>

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, *i.e.*, 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 reasonable contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. 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. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract. For, had the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them.

Damages for breach of contract are intended, as far as money can, to put the plaintiff in the same position that the plaintiff would have been in if the contract had not been breached. These damages typically provide compensation to the innocent party based on the benefit of the bargain that it expected to receive (*i.e.*, its expectation interest)<sup>15</sup> and not just out-of-pocket losses or expenses that were wasted as a result.<sup>16</sup> This may even require a court to determine an appropriate measure of damages to compensate not just for the losses that occurred on the day of the breach but also damages that recognize the time-value of money.<sup>17</sup>

This principle is not intended to give the plaintiff complete indemnity for all of its losses, however, it is limited to those losses “such as may fairly and reasonably be considered either arising naturally ... from the breach of contract itself, or such as may reasonably be supposed to

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<sup>14</sup> *Hadley v. Baxendale* (1854), 156 E.R. 145, 9 Exch. 341 (Eng. Exch.), at p. 151 (E.R.).

<sup>15</sup> Less frequently, damages may also be awarded on the basis of restitution — requiring the breaching party to disgorge the benefit of the breach. See *Bank of America Canada v. Mutual Trust Co.*, 2002 SCC 43 (S.C.C.), at paras. 26 and 30.

<sup>16</sup> See Stephen M. Waddams, *The Law of Contracts*, 7th ed. (Toronto: Thomson Reuters, 2017), at para. 703 (“Waddams, *Contracts*”).

<sup>17</sup> *Bank of America, supra*, footnote 15, at paras. 21-22.

have been in the contemplation of both parties.”<sup>18</sup> That is, “[t]he law’s task is simply to provide the benefits contracted for, whatever their nature, if they were in the reasonable contemplation of the parties.”<sup>19</sup>

The law is clear that the innocent party may seek to recover a variety of losses as damages, including:

- the cost of remedying a defect (*e.g.*, by repairing or replacing the defective product as well as any other physical damage or loss caused by its failure);
- compensation for the diminished value of a product; and
- the profits lost during the time a defective product was being repaired or replaced by an adequate substitute.

Damages may also include less immediate or obvious losses, however, such as:

- loss of business or subsequent sales;
- the cost of financing or other expenditures, such as payroll expenses; and
- loss of future business opportunities.

Identifying the potential kinds of losses a party may suffer tells us little, however, about whether the losses fall into the categories of “direct”, “general”, “consequential”, “special”, “incidental”, or “indirect” damages. Rather, each of these kinds of loss is recoverable if it arises naturally from the contractual breach or was in the reasonable contemplation of the parties in the particular circumstances. Regardless of how the particular loss is described, all losses are *prima*

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<sup>18</sup> *Fidler v. Sun Life Assurance Co. of Canada*, 2006 SCC 30 (S.C.C.), at para. 27, citing *Hadley*, *supra*, footnote 14, at p. 151. See also *Victoria Laundry (Windsor) Ltd. v. Newman Industries Ltd.*, [1949] 2 K.B. 528 (C.A.), at pp. 539-540, where Asquith L.J. set out the following principles:

(1) It is well settled that the governing purpose of damages is to put the party whose rights have been violated in the same position, so far as money can do so, as if his rights had been observed. This purpose, if relentlessly pursued, would provide him with complete indemnity for all loss de facto resulting from a particular breach, however improbable, however unpredictable. This, in contract at least, is recognized as too harsh a rule. Hence,

(2) In cases of breach of contract the aggrieved party is only entitled to recover such part of the loss actually resulting as was at the time of the contract reasonably foreseeable as liable to result from the breach.

(3) What was at that time reasonably so foreseeable depends on the knowledge then possessed by the parties or, at all events, by the party who later commits the breach.

(4) For this purpose, knowledge “possessed” is of two kinds; one imputed, the other actual. Everyone, as a reasonable person, is taken to know the “ordinary course of things” and consequently what loss is liable to result from a breach of contract in that ordinary course. This is the subject-matter of the “first rule” in *Hadley v. Baxendale*, but to this knowledge, which a contract-breaker is assumed to possess whether he actually possesses it or not, there may have to be added in a particular case knowledge which he actually possesses of special circumstances outside the “ordinary course of things” of such a kind that a breach in those special circumstances would be liable to cause more loss. Such case attracts the operation of the “second rule” so as to make additional loss so recoverable.

(5) In order to make the contract-breaker liable under either rule, it is not necessary that he should actually have asked himself what loss is liable to result from a breach. As has often been pointed out, parties at the time of contracting contemplate not the breach of the contract, but its performance. It suffices that, if he had considered the question, he would as a reasonable man have concluded that the loss in question was liable to result (see certain observations of Lord du Parc in the recent case of *A/B Karlshamns Oljefabriker v. Monarch Steam Ship Company Limited*).

(6) Nor, finally, to make a particular loss recoverable, need it be proved that upon a given state of knowledge the defendant could, as a reasonable man, foresee that a breach must necessarily result in that loss. It is enough if he could foresee it was likely so to result. It is indeed enough, to borrow the language of Lord du Parc in the same case, at page 158, if the loss (or some factor without which it would not have occurred) is a “serious possibility” or a “real danger.” For short, we have used the word “liable” to result. Possibly a colloquialism “on the cards” indicates the shade of meaning with some approach to accuracy. [Citations omitted]

<sup>19</sup> *Fidler*, *supra*, footnote 18, at para. 44.

*facie* recoverable where they: (i) were reasonably foreseen or contemplated by the parties; (ii) are causally connected to the breach; and (iii) are not too remote. How a particular kind of loss is characterized is not really important unless the parties agreed to exclude or limit liability for certain losses.

The Supreme Court of Canada has affirmed the rule in *Hadley* as the only rule regarding the recovery of contractual damages and it unites all forms of contract damages under a single principle: what was in the reasonable contemplation of the parties at the time the contract was formed. The court should ask “what did the contract promise?” and attempt, as much as money can, to restore the plaintiff to the position it would have been in if the contract had been performed.<sup>20</sup>

Courts and commentators have generally understood *Hadley* as having created two branches of recoverable damages, distinguished on the basis of foreseeability:

1. *Objectively foreseeable damages*: These are losses that may “fairly and reasonably be considered” as arising naturally in the usual course from the breach of contract or which “may be reasonably supposed to have been in the contemplation of both parties . . . as the probable result of the breach” when the parties formed the contract (the “First Branch”).
2. *Special circumstances damages*: These are losses that arise outside of the usual course due to special circumstances in which the contract was made. These losses are in addition to losses falling within the First Branch. Damages for these losses are recoverable if: (i) the special circumstances were communicated by the non-breaching party to the other and were therefore known to both parties and (ii) are the kind of losses that the parties would reasonably contemplate to ordinarily follow the breach of the contract in the special circumstances in which the contract was made (the “Second Branch”).<sup>21</sup>

The recoverability of damages for losses under the First Branch and the Second Branch is based on the related concepts of foreseeability and remoteness.<sup>22</sup> Under the First Branch, foreseeability is determined objectively (“as may reasonably be supposed to have been in the contemplation of both parties” or of a kind “not unlikely” to arise from a breach). Under the Second Branch, what the parties reasonably contemplated (or foresaw) is based on the subjective knowledge of the parties. Losses under the Second Branch would not ordinarily be in the parties’ reasonable contemplation, but become so due to the parties’ subjective knowledge of one or both of the parties’ special circumstances in making the contract. Losses that do not fall under either

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<sup>20</sup> *Fidler, supra*, footnote 18, at para. 44.

<sup>21</sup> These two branches have been subsequently described as constituting a single rule based on reasonable foreseeability, either based on imputed knowledge or on the basis of the actual knowledge of the parties. The description of the two types of foreseeability as two branches or rules was made by Asquith L.J. in *Victoria Laundry, supra*, footnote 18, at pp. 539-540 and has persisted throughout Anglo- Canadian and American common law. See *e.g., BHP Petroleum Ltd. v. British Steel Plc.*, [1999] 2 All E.R. (Comm) 544 (Eng. Comm. Ct.), at pp. 563-567 (Justice Rix discussing the problems of foreseeability and the distinction between the first and second “limb” of *Hadley v. Baxendale*); Glenn D. West and Sara G. Duran, “Reassessing the ‘Consequences’ of Consequential Damage Waivers in Acquisition Agreements” (2008), 63:3 *The Business Lawyer* 777, at p. 785 (discussing the two branches of *Hadley v. Baxendale*).

<sup>22</sup> Remoteness is a means of limiting recovery of foreseeable losses. If losses do not fall in either the First Branch or Second Branch, they are too remote and are not recoverable, even if theoretically foreseeable and causally linked to the breach.

branch are not foreseeable and are not recoverable, even if the losses were part of the chain of events caused by the breach.<sup>23</sup> These losses are described as being too remote to be recovered.<sup>24</sup>

While *Hadley* remains the only rule for the assessment of damages, Alderson B.'s distinction between types of losses continues to cause difficulty and confusion in its application. Efforts by judges and academics to explain why losses in one set of circumstances fall under one rule and not the other have perhaps even obscured the distinction. The more commentators try to explain how different losses should be characterized and treated, the more complicated and uncertain the distinction seems to become.

#### IV. DEFINING CONSEQUENTIAL DAMAGES

As a single, unifying principle, the utility for practitioners of this split between the First and Second Branches is undermined by the fact that losses are often distinguished on the basis of causal connections. While losses under the First Branch are sometimes called “general” damages (*i.e.*, the kind of losses that anyone would suffer), they are also often called “direct” damages. In this sense, they are described as being the immediate or direct result of the breach. For example, Professor Gerald Fridman has written that to recover direct damages, the plaintiff’s losses “must have been the direct, physical result or consequence of the breach of contract in question”, or, in other words, losses “which flow naturally from the breach without any other intervening cause, and independently of special circumstances.”<sup>25</sup> Note his use of the word “consequence”: this suggests that Fridman’s definition of “direct” damages includes “consequential damages”.

But losses falling under the Second Branch are often called “consequential damages”, despite the fact that they are not necessarily “consequential” as that word is commonly used.<sup>26</sup> They are also frequently referred to as “indirect” damages (*i.e.*, they are not direct damages under the First Branch), a term that will be discussed later in this article. The adjective “consequential”, in its ordinary meaning, describes some degree of causation between one event and another. Seen this way, direct damages could be understood as the immediate results of the breach of contract. Indirect or consequential damages, being less directly connected to the breach, could then be understood as losses that are the consequence of those immediate results.<sup>27</sup> They have accordingly been referred to as the “‘knock-on’ effects” of a breach of contract.<sup>28</sup>

However, Alderson B.’s description of recoverable losses in *Hadley* is based on foreseeability and not the causal relationship between the breach and the loss.<sup>29</sup> Indeed, courts have often been willing to consider more than just the immediate results of a breach of contract as

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<sup>23</sup> G.L.H. Fridman, *The Law of Contract in Canada*, 6th ed. (Toronto: Carswell, 2011), at pp. 683-684, Swan and Adamski, *supra*, footnote 2, at pp. 509-511.

<sup>24</sup> The common law has been codified in provincial sale-of-goods legislation, such as s. 51(2) of Ontario’s Sale of Goods Act, which provides: “The measure of damages for breach of warranty is the estimated loss directly and naturally resulting in the ordinary course of events from the breach of warranty.” Sale of Goods Act, R.S.O. 1990, c. S.1. This article will not discuss sale-of-goods legislation or cases except to the extent that they address common law principles regarding the recoverability of lost profits as damages. See, e.g., *Canlin Ltd. v. Thiokol Fibres Canada Ltd.* (1983), 40 O.R. (2d) 687, 1983 CarswellOnt 136 (Ont. C.A.).

<sup>25</sup> Fridman, *supra*, footnote 23, at p. 683.

<sup>26</sup> See, e.g., *Kocken Energy Systems Inc. v. Fulton Engineered Specialities Inc.*, 2017 NSSC 103 (N.S. S.C.); and see E Jane Sindell, “Consequential Damages: Are Exclusions of Consequential Damages Inconsequential?” (2010), *J. Can. C. Construction Law* 109.

<sup>27</sup> Swan and Adamski, *supra*, footnote 2, at p. 413. See also *Westcoast Transmission Co. v. Cullen Detroit Diesel Allison Ltd.* (1990), 45 B.C.L.R. (2d) 296, 1990 CarswellBC 92 (B.C. C.A.); *Agfaphoto Canada Inc. v. Overwaita Food Group Ltd.*, 2008 BCSC 1287 (B.C. S.C.).

<sup>28</sup> *BHP Petroleum, supra*, footnote 21, at p. 568.

<sup>29</sup> Although the more causally remote, the less reasonably foreseeable the damages become.

direct damages and include “knock-on” effects under that heading, focusing not on causation but on foreseeability and the expectations of the parties.

The difficulty created by the different legal meanings of direct and indirect damages is easily illustrated. Take a contract where a construction company buys a new generator. It bought the generator on the representation that it was new and it could meet a specific power output at a specific fuel efficiency. The sales contract included a general exclusion of “consequential damages”. The generator delivered was not new and had been used on two previous jobs. After a week of use, it failed, causing an electrical fire that damaged other equipment and property. The time needed by the construction company to either repair or replace the generator and the other damaged equipment and property will leave it unable to meet the project schedule and it will be assessed delay penalties by the owner. As is often the case, the losses the construction company will be able to recover from the seller will depend not only on the terms of the contract, but also on what it does in the aftermath.

The construction company’s direct damages would include either: (a) the difference between the price for which it agreed to buy the generator and the market price to buy a new generator that was actually capable of meeting the performance specifications, if it chooses to replace the generator; or (b) its repair costs (which may or may not be covered by a contractual warranty) if it instead chooses to repair the generator.

In addition, the construction company may suffer less immediate losses such as the costs to repair or replace the other damaged equipment and property, its wasted overhead while various trades were unable to work, and potentially, its lost profits and assessed penalties because it was unable to keep its schedule for the project owner.<sup>30</sup> These losses, however, would not necessarily fall under the Second Branch or be labelled consequential damages, as the term is used in the cases. Some of these losses, such as the costs to replace other equipment and wasted overhead, are every bit as foreseeable as the costs to repair or replace the generator. Other losses, such as lost profits resulting from penalties, may not be foreseeable at all unless the seller knew that the generator was being purchased to meet a specific schedule that would be enforced by penalties.

So which losses are consequential damages? The confusion is perhaps best exemplified by how consequential damages are defined in *Black’s Law Dictionary*:<sup>31</sup>

Such damage, loss or injury as does not flow directly and immediately from the act of the party, but only from some of the consequences or results of such act. Damages which arise from intervention of special circumstances not ordinarily predictable. Those losses or injuries which are the result of an act but are not ordinarily predictable. Those losses or injuries which are a result of an act but are not direct and immediate. Consequential damages resulting from a seller’s breach of contract include any loss resulting from general or particular requirements and

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<sup>30</sup> See also Christa Brothers and Tipper McEwan, “Consequential Damages for Breach of Contract: A Primer on Principles” in Todd L. Archibald and Randall Echlin, eds., *Annual Review of Civil Litigation, 2011* (Toronto: Thompson Reuters Canada) (online). In other cases, for example, in the case of a distributor that sells on goods purchased from a manufacturer after slight modification, direct losses may include the additional costs a buyer incurs while defective equipment or goods are being repaired or replaced, or even the buyer’s profits that are lost on the sub-sale of the goods supplied or while revenue producing equipment is being repaired or replaced.

<sup>31</sup> Joseph R. Nolan, *Black’s Law Dictionary*, 6th ed. (St. Paul, Minnesota: West Publishing Co., 1990), at p. 390, cited in Brothers and McEwan, *supra*, footnote 30.

need of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise, and injury to person or property proximately resulting from any breach of warranty.

This definition captures both how consequential damages could be defined by reference to foreseeability and the Second Branch of *Hadley* and also how consequential damages could be defined by reference to the causal connection between a breach and a resultant loss. Under this definition, “consequential damages” is a term too ambiguous and confusing for the contract drafter to use.

This aligns with the assessment of Glenn D. West and Sara G. Duran who have noted that “consequential damages” is a “shockingly ambiguous” term in United States law.<sup>32</sup> As in Canada, parties frequently use boilerplate provisions waiving consequential damages despite the fact that U.S. case law does not give clear meaning as to what losses this would exclude. Also as in Canada, much of the confusion about the meaning of the term “consequential damages” has its origin in the framework for understanding damages set out in *Hadley*.<sup>33</sup> West and Duran reach largely the same conclusion as drawn in this article: consequential damages are best understood as losses falling under the Second Branch, and deal lawyers should not assume that consequential losses suggest a degree of causation, intervention of other causes, or that they refer to losses suffered beyond the immediate breach. Similar confusion exists in English law. For instance, in his influential treatise on damages, Harvey McGregor has described consequential damages as:<sup>34</sup>

[T]hat loss which is special to the circumstances of the particular claimant. In contract, the normal loss can generally be stated as the market value of the property, money or services that the claimant should have received under the contract, less either the market value of what he does receive or the market value of what he would have transferred but for the breach. Consequential damages particular to the claimant include anything beyond this normal measure, such as profits lost or expenses incurred through the breach and are recoverable if not too remote.

McGregor initially defines consequential losses as being losses arising in the “special circumstances of the particular claimant”, which typically would be thought of as losses that fall under the Second Branch. His explanation of what losses are “normal losses” and those that are “consequential losses”, however, seems to introduce the notion of causation — consequential losses are those beyond the “normal measure”, but also, the immediate breach. In all, it is questionable whether his distinction between “normal” damages and “consequential” damages is the same as that in the First Branch and the Second Branch. The types of losses that he gives as examples of anything beyond this “normal measure”, such as lost profits, are actually losses that could fall within the First Branch.<sup>35</sup>

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<sup>32</sup> West and Duran, *supra*, footnote 21, at p. 780. See also Glenn D. West, “Consequential Damages Redux: An Updated Study of the Ubiquitous and Problematic ‘Excluded Losses’ Provision in Private Company Acquisition Agreements” (2015), 70:4 *The Business Lawyer* 971.

<sup>33</sup> West and Duran, *supra*, footnote 21, at p. 788. Many of the terms discussed in this article are discussed in West and Duran’s article from a U.S. perspective.

<sup>34</sup> Harvey McGregor, *McGregor on Damages*, 20th ed. (London: Sweet & Maxwell, 2018), at para. 3-008.

<sup>35</sup> In *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*, 2018 ABQB 482 (Alta. Q.B.), at para. 1021, Romain J. describes this statement as:

[P]roblematic, particularly as the author now appears to be suggesting that there should be a different interpretation of consequential where an exclusion clause is being interpreted rather than the one that is applied more generally. I agree with the court in *Hotel Service [Ltd. v. Hilton*

Unsurprisingly, courts have also struggled with how to allocate losses between the two branches and among the various terms. Justice Rix, of the Commercial Court of England and Wales addressed the difficulty posed by defining direct and indirect or consequential damages according to the First and Second Branches in *BHP Petroleum Ltd.*<sup>36</sup> His analysis allowed three possibilities where a contract excludes liability for consequential damages: (i) the losses fall in the First Branch and they are not excluded by the exclusion; (ii) the losses fall in the Second Branch and are excluded; and (iii) the losses fall in neither and are too remote for recovery. The distinctions between these categories, however, are difficult to apply. What is the difference between losses that are not recoverable under the Second Branch because the relevant special circumstances were not communicated (and therefore the losses were not foreseeable and too remote) and damages that are simply too remote? Once a party has knowledge of the special circumstances, how is the difference between the First Branch and Second Branch meaningful when the damages were then foreseeable and therefore recoverable? As Rix J. noted:<sup>37</sup>

What, however, is to happen where the *Hadley v. Baxendale* rule is used as the critical test of what are “consequential losses” for the purposes of an exclusion in those terms? If any loss which, on the facts of the case, is within the contemplation of the parties is treated as being within the first limb of the rule, then the exclusion is redundant and useless. How does one tell the difference between losses which are in the contemplation of the parties within the first limb, and other losses which are only within the contemplation of the parties because of special knowledge within the second limb?

English Courts have recently appeared open to understanding consequential damages more broadly and more contextually, particularly where sophisticated parties have attempted to allocate risk using their own definitions of consequential or indirect losses. The English Court of Appeal in *Transocean Drilling UK Ltd. v. Providence Resources Plc.* even pondered whether earlier decisions dealing with the exclusion of consequential damages, such as *Deepak Fertilisers & Petrochemicals Corp. Ltd. v. ICI Chemicals & Polymers Ltd.*,<sup>38</sup> might be decided differently today “when courts are more willing to recognize that words take their meaning from their particular context and that the same word or phrase may mean different things in different documents”.<sup>39</sup>

Indeed, in *Star Polaris LLC v. HHIC-PHIL Inc.*, the Commercial Court of England and Wales came to the view that the terms “consequential” or “special losses” can have a wider meaning than losses falling within the Second Branch where it is clear that this is what the parties intended. The court upheld an arbitration decision that held that the phrase “consequential or

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*International Hotels (UK) Ltd.*, [2000] All E.R. 750 (Comm) (C.A.)] that the comments made in McGregor are unconvincing in their premise and the reasoning that would accept different meanings of consequential damages depending on the usage in a particular contract is an awkward method of resolving a problem.

<sup>36</sup> *BHP Petroleum*, *supra*, footnote 21, at pp. 566-568. Commenting on the difficulty he had with this issue in *Deepak Fertilisers & Petrochemicals Corp. Ltd. v. ICI Chemicals & Polymers Ltd.*, [1998] 2 Lloyd’s Rep. 139 (Q.B. (Comm. Ct.)), he noted:

I approach the topic with the diffidence of one who has already fallen into error in connection with it once. I find it conceptually difficult.

In effect the critical reasoning of the authorities is to lay stress on what may be contemplated as occurring in the ordinary course of things. That is both direct, natural and immediate: everything else is indirect or consequential.

He questioned, however, whether one was to tell the difference between what ought to be known, and thus imputed to the parties, and what was actually known in the circumstances only because of special knowledge. *BHP Petroleum*, *supra*, footnote 21, at p. 566.

<sup>37</sup> *BHP Petroleum*, *supra*, footnote 21, at p. 566.

<sup>38</sup> *Deepak Fertilisers & Petrochemicals Corp. Ltd. v. ICI Chemicals & Polymers Ltd.*, [1999] 1 Lloyd’s Rep. 387 (Eng. Ch. Div., C.A.). See also *Saint Line Ltd. v. Richardsons Westgarth & Co.*, [1940] 2 K.B. 99 (Eng. K.B.); *Croudace Construction Ltd. v. Cawoods Concrete Products Ltd.*, [1978] 2 Lloyd’s Rep. 55 (Eng. & Wales C.A. (Civil)).

<sup>39</sup> *Transocean Drilling UK Ltd. v. Providence Resources Plc.*, [2016] EWCA Civ 372, at para. 15.

special losses, damages or expenses” was intended by the parties to exclude not just losses within the Second Branch but also losses that would typically fall within the First Branch.<sup>40</sup>

*Star Polaris* deserves a closer look. The defendant was a shipbuilder. The *Star Polaris* suffered a serious engine failure and the owner sought to recover its repair costs and expenses, as well as damages for its lost use of the vessel. The contract for the purchase of the ship had been extensively negotiated and provided for a complete code allocating the risks of any losses. The contract provided a 12-month guarantee for material and workmanship and set out the ship builder’s responsibility for costs associated with remedying defects and repairing physical damage caused by covered defects if the repairs had to be carried out by a third party. The contract contained a limitation of liability that provided:<sup>41</sup>

Except as expressly provided in this Paragraph, in no circumstances and on no ground whatsoever shall the BUILDER have any responsibility or liability whatsoever or howsoever arising in respect of or in connection with the VESSEL or this CONTRACT after delivery of the VESSEL. Further, but without in any way limiting the generality of the foregoing, the BUILDER shall have no liability or responsibility whatsoever or howsoever arising for or in connection with any consequential or special losses, damages or expenses unless otherwise stated herein.

The owner of the ship argued that damages for its loss of use were not “consequential” or “special” losses that it claimed could only fall within the Second Branch. The arbitrators and the court disagreed. The contractual guarantee set out a complete code, excluding other liabilities imposed by statute, common law or custom. The guarantee was expressed to be the full extent of the builder’s liability. In order to give effect to the parties’ intentions (taking into account the words “except as expressly provided” and “whatsoever or howsoever arising”), the words “consequential or special losses” had to be given a broader meaning than losses under the Second Branch.<sup>42</sup>

The contractual allocation of risk and losses differentiated between the cost of repair or replacement and the broader financial consequences that resulted from the need for repairs or replacement.<sup>43</sup> These losses were expressly stated to be the *full* extent of the ship builder’s liability. As a result, the court concluded that the arbitrators correctly determined that the exclusion of “consequential or special losses” included all losses *other than* those for which the shipbuilder expressly undertook to compensate the ship owner. These losses included not only losses that fell in the Second Branch but also financial losses caused by the defects, above and beyond the replacement and repair of physical damage, whether or not these financial losses would otherwise fall within the First Branch.<sup>44</sup>

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<sup>40</sup> *Star Polaris LLC v. HHIC-PHIL Inc.*, [2016] EWHC 2941 (Comm), [2016] 2 C.L.C. 832 (Q.B. Comm. Ct.), at para. 39.

<sup>41</sup> *Star Polaris LLC*, *supra*, footnote 40, at para. 8.

<sup>42</sup> *Star Polaris LLC*, *supra*, footnote 40, at para. 39. This result stands in contrast with that of Ontario Superior Court in *Atos IT Solutions and Services GMBH v. Sapient Canada Inc.*, 2016 ONSC 6852 (Ont. S.C.J. [Commercial List]) (“*Atos IT* (Ont. S.C.J.)”), varied (but not on this issue), varied 2018 ONCA 374 (Ont. C.A.) (“*Atos IT* (Ont. C.A.)”), discussed below.

<sup>43</sup> *Star Polaris LLC*, *supra*, footnote 40, at para. 36.

<sup>44</sup> *Star Polaris LLC*, *supra*, footnote 40, at para. 39.

More surprisingly, the court, summarizing the arbitrator's views with approval, stated that "the word 'consequential' had to mean that which *follows as a result or consequence of the physical damage, namely additional financial loss other than the cost of repair or replacement*".<sup>45</sup> These are not "consequential" damages in the meaning of *Hadley*. Rather, the court adopted the more common conception of consequential damages as being damages that are the consequence or result of the immediate (and physical) losses caused by the breach: the very type of damages that under *Hadley* should be recoverable.

The situation appears quite different in Canada, where there is a similar, albeit a minority view, that defines consequential damages in terms of their causal relationship to the breach. That is, they are losses other than the immediate losses caused by the breach. The most often discussed case in this regard is *Agfaphoto Canada Inc. v. Overwaitea Food Group Ltd.*, where Holmes J. relies on McGregor's definition of "consequential losses" as well as Angela Swan's text on Canadian contract law to conclude that consequential damages are losses that arise "as a consequence of the direct damages" caused by the breach.<sup>46</sup>

Some of these cases, as well as McGregor, are further cited in a 2011 article on consequential damages by Christa Brothers and Tipper McEwan. The authors looked to definitions of "con-sequential" from various legal dictionaries as well as McGregor's definition and concluded that consequential damages "are losses that are at least once removed from the breach of contract." In their view, "intuitively, the distinction between direct and consequential damages makes a great deal of sense. Direct damages require comparatively little legal analysis because they do not raise the same, troubling policy questions as consequential damages."<sup>47</sup> As reasonable as this may seem, unfortunately, this distinction tends to vanish in the case law.

Finding a way to reconcile the differing results in the jurisprudence, if possible, to apply them and determine what losses are consequential damages will depend on the facts of each case. What losses may be or when certain losses will be consequential damages must be determined in light of the factual matrix in which the contract was negotiated, including the nature of the transaction, and with regard to the exact language of the exclusion or limitation clause. For example, in cases where the buyer entered into a contract to acquire revenue-producing assets, such as a piece of equipment or a business, compensation for the loss of that revenue or profits will almost always be found to be direct damages.<sup>48</sup> In such cases, the parties would have reasonably foreseen that a breach would result in lost profits. The profits were the whole object of the contract.<sup>49</sup> If, however, the buyer bought a component for use as part of a larger operation, a

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<sup>45</sup> *Star Polaris LLC, supra*, footnote 40, at para. 36 (emphasis added).

<sup>46</sup> *Agfaphoto, supra*, footnote 27, at para. 25, citing John Swan, *Canadian Contract Law*, 1st ed. (Toronto: LexisNexis, 2006), at pp 296-297.

<sup>47</sup> Brothers and McEwan, *supra*, footnote 30.

<sup>48</sup> See e.g., *Freedhoff v. Pomalift Industries Ltd.*, [1971] 2 O.R. 773, 1971 CarswellOnt 661 (Ont. C.A.). See also *Ticketnet Corp. v. Air Canada*, 1993 CarswellOnt 2046 (Ont. Gen. Div.), in which the parties entered a joint venture agreement to develop a software system that the parties intended to use to sell tickets in different industries. Air Canada was found to have willfully and deliberately breached the contract so as to deprive Ticketnet of the benefit of the project, without compensation (or with minimal compensation). The purpose of the venture, and the expectation of each party, was to make a profit from the computer system. Justice Farley found that Ticketnet's proven lost profits were direct and not consequential damages (which were subject to a \$2 million limitation of liability). It is in this context that Farley J. stated:

Surely no one would expect to receive an answer from not only Ticketnet but AC as well, that such conduct on the part of AC would be allowed provided only that AC might have to pay for up to \$2 million for direct losses suffered by Ticketnet. I note that it is clear that indirect or consequential damages do not include loss of profit (upon which Ticketnet's claim is based) [citation omitted]. [*Ticketnet, supra*, at para. 162.]

This decision was subsequently varied on appeal but not on this issue. See *Ticketnet Corp. v. Air Canada* (1997), 154 D.L.R. (4th) 271, 105 O.A.C. 87 (Ont. C.A.).

<sup>49</sup> See e.g., *Synchrude Canada Ltd. v. Babcock & Wilcox Canada Ltd.*, 1997 ABCA 179 (Alta. C.A.) (discussed below).

court may be more inclined to conclude that lost revenue or profits are only recoverable if it was made clear to the parties that the equipment was critical to overall production.<sup>50</sup> Each decision will take into account, to some extent, whether such losses were not only in the reasonable contemplation of the parties, but were also reasonably recoverable.

## V. SPECIAL, INCIDENTAL AND OTHER KINDS OF DAMAGE

Limitation and exclusion clauses also typically exclude more than just consequential losses — whatever those may actually be. Many clauses will also exclude “indirect”, “special”, “incidental”, “punitive” and “exemplary” damages. These additional kinds of losses are included in an effort to comprehensively exclude all damages other than whatever the parties would consider the direct, foreseeable damages resulting from a breach or the damages covered by any contractual warranty.

The meanings of “exemplary”, “punitive” and “aggravated” damages are fairly well understood; much more so than the meaning of “consequential” damages. Exemplary damages are the same as punitive damages. Both are supra-compensatory damages awarded to punish the breaching party for its conduct, and not to compensate the plaintiff for its losses. Aggravated damages, in contrast, are still compensatory, but are a heightened award recognizing the severity of the plaintiff’s loss in light of the particular circumstances. Yet, “exemplary”, “punitive” and “aggravated” damages are typically excluded in the same breath even though they are not the same thing at all.

The same confusion exists for other types of damages, such as “special”, “indirect” or “incidental” damages. The meaning of these terms is complicated by the fact that most exclusion or limitation clauses will also exclude liability for damages in tort, including negligence. As a result, it appears that both lawyers and trial judges confuse the meaning of general damages and special damages as they are used in tort, even when a plaintiff’s claim is brought in contract.

“Special damages” is a phrase more commonly used in tort law than in contract. Special damages, at least in tort, are understood to be pecuniary losses that are suffered before trial and which the plaintiff can readily calculate.<sup>51</sup> In contract, many types of losses are readily calculable, like the cost of repairing or replacing defective equipment, and therefore could be “special damages” in addition to being damages under either the First Branch or the Second Branch. In *New Brunswick Power Corp. v. Westinghouse Canada Inc.*, the New Brunswick Court of Appeal upheld the trial judge’s decision that “special damages” did not have a different meaning in contract from tort and concluded that the plaintiff’s claim for the expenses it incurred to repair defective equipment were excluded as “special damages” and not recoverable “general damages”.<sup>52</sup> These losses, however, would normally have been recoverable under the First Branch as damages resulting in the ordinary course. Looking at how the losses under the First Branch may

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<sup>50</sup> *Hadley*, *supra*, footnote 14. This is certainly the prevailing view in English law: see *British Sugar Plc v. NEI Power Projects Ltd.*, 1997 WL 1104071, [1997-1998] 87 B.L.R. 43 (C.A.); *Deepak* (C.A.), *supra*, footnote 38; *McCain Foods GB Ltd. v. ECO-Tec (Europe) Ltd.*, [2011] EWHC 66 (TCC); *BHP Petroleum*, *supra*, footnote 21, affirmed [2000] 2 Lloyd’s Rep. 277 (C.A.).

<sup>51</sup> Daphne Dukelow, ed., *The Dictionary of Canadian Law*, 4th ed. (Toronto: Carswell, 2011), *sub verbo* “special damages”.

<sup>52</sup> *New Brunswick Power*, *supra*, footnote 10, at para. 37 (accepting the trial judge’s finding that the costs of repairing and replacing defective transformers were special damages and could not be recovered as general damages).

be alternatively described, one would have expected that these losses would be considered direct damages and not special damages.

The Newfoundland and Labrador Supreme Court took a similar approach in assessing damages in *Star Line Inc. v. Hydro-Mac Inc.*<sup>53</sup> Noting that “[d]amages are generally limited to those that ordinarily flow from the breach and which the parties might reasonably have contemplated when they made the contract”, the court awarded the plaintiff “special damages” that included the costs to repair a negligently designed crane (e.g., parts and labour), inspection fees and additional port fees incurred while the crane was being repaired.<sup>54</sup> In addition, the court allowed the plaintiff’s claim for unspecified “general damages” of \$10,000 for “the unnecessary inconvenience and expense [the plaintiff] incurred because of [the defendant’s]’s lack of care”.<sup>55</sup> This category was similarly applied in *Sunnyside Greenhouses Ltd. v. Golden West Seeds Ltd.*, a decision of the Alberta Supreme Court (Appellate Division), in which the plaintiff’s lost gross sales were claimed as “general damage” and not as “special damage for loss of particular customers”.<sup>56</sup>

“Indirect damages” are sometimes described as the equivalent of consequential losses, apparently for no reason other than that they are losses that are not direct losses.<sup>57</sup> This partly appears to be a result of the direct-consequential damages dichotomy created by *Hadley*. If indirect losses are synonymous with “consequential” losses, and refer to damages under the Second Branch, then the term “indirect” would refer to those losses that are foreseeable with special knowledge of the circumstances. The term “indirect”, just like the term “consequential”, however, is commonly thought of as suggesting a particular degree of causation or even temporal separation from the immediate results of a breach of contract.

“Incidental damages”, at least in a sale of goods context, include costs that are made necessary by the breach, such as the costs of removing or returning defective or rejected goods. Again, these losses may be readily calculable, so they could also be special damages. More generally, incidental losses are thought of as losses that are reasonably associated with or have some connection to the breach. Like “consequential”, the ordinary meaning of “incidental” appears to connote a certain causal relationship between these losses and other, more immediate, damages, since incidental losses are an incident, or the result, of the immediate breach.<sup>58</sup> These losses may fall under either the First Branch or the Second Branch depending on whether the costs would arise in the ordinary course or were reasonably foreseeable in the particular circumstances. However, the category of incidental damages is most relevant in the context of a sale of goods and it appears to be more limited than, and conceptually distinct from, “consequential” damages.

No Canadian court has precisely or definitively examined where these categories of damages fall within the dichotomy created by *Hadley*’s First and Second Branches. Thus, a clause

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<sup>53</sup> *Star Line Inc. v. Hydro-Mac Inc.*, 2008 NLTD 73 (N.L. T.D.).

<sup>54</sup> *Star Line Inc. v. Hydro-Mac Inc.*, *supra*, footnote 53, at paras. 83-100.

<sup>55</sup> *Star Line Inc. v. Hydro-Mac Inc.*, *supra*, footnote 53, at para. 101.

<sup>56</sup> *Sunnyside Greenhouses Ltd. v. Golden West Seeds Ltd.* (1972), 27 D.L.R. (3d) 434, 1972 CarswellAlta 51 (Alta. C.A.), at para. 19. See also *Kocken Energy Systems*, *supra*, footnote 26.

<sup>57</sup> *Westcoast Transmission*, *supra*, footnote 27; *Premium Grain & Seed Ltd. v. Finora Canada Ltd.* (1999), 181 Sask. R. 19, 1999 CarswellSask 394 (Sask. Q.B.); see also Bryan A. Gardiner, ed., *Black’s Law Dictionary*, 11th ed. (St Paul, Minnesota: Thompson Reuters, 2019), *sub verbo* “damages – indirect damages”.

<sup>58</sup> Dukelow, *supra*, footnote 51, *sub verbo* “incidental” and “consequential damages”; Gardiner, *supra*, footnote 57, *sub verbo* “damages – incidental damages” and “damages – consequential damages”.

in a share or asset purchase agreement excluding them may unintentionally disqualify a plaintiff from claiming damages that would otherwise have clearly been recoverable under the First Branch. This is especially the case for special and incidental damages, which have particular associations with tort and the sale of goods, respectively. Again, we suggest that it would be a mistake, based on the current jurisprudence, to assume that special, indirect or incidental damages are generally understood as synonyms for each other or consequential damages. Each have a slightly nuanced meaning, and none have taken on a specialized meaning placing them solely within the Second Branch. As with consequential damages, a buyer would likely want to resist excluding liability for these kinds of losses. In contrast, a seller might want some or all of these terms included in a clause that excludes, waives or limits its liability to the buyer if it wished to extend its protection to damages within the Second Branch.

## VI. THE PROBLEM OF LOST PROFITS

Lost profits are perhaps the category of loss with the greatest number of potential pitfalls when it comes to limiting or excluding a party's liability. Lost profits are no different from any other losses resulting from a breach of contract, but there is a persistent view among practitioners that lost profits are specifically a form of consequential loss. For example, the following passage from a leading text on remedies expressly describes lost profits as a subcategory of consequential loss: "When a contract has been breached, the plaintiff may be deprived not only of the immediate benefit of the contract but may also suffer other consequential losses including wasted expenses and lost profits."<sup>59</sup> This view reflects the common, and often incorrect, assumption that lost profits are consequential losses because they are not an immediate result of the breach but were caused by or the "consequence" of the immediate result.

Damages for lost profits are recoverable on the same principles as any other form of contractual damages and, in many ways, can embody the very meaning of a buyer's expectation interest. Indeed, as noted by Cory J.A. (as he then was) in *Canlin Ltd. v. Thiokol Fibres Canada Ltd.*, most commercial contracts for the sale and delivery of goods are entered into with a view to profit — "[t]o say otherwise amounts to a denial of the profit motive in the free enterprise system."<sup>60</sup> Damages for lost profits can thus fall under either the First Branch or Second Branch and will be recoverable if the loss was within the reasonable contemplation of the parties at the time they entered into the agreement, either as a "direct and natural consequence" in the ordinary course or because of special circumstances known to the parties.<sup>61</sup> So long as a buyer can show on a balance of probabilities that it lost profits because of a breach, then its proven losses should be recoverable.<sup>62</sup> This was the Ontario Court's conclusion in *Atos IT Solutions v. Sapient Canada* as well.<sup>63</sup> In a fixed-price contract for services, lost profits can be a form of direct damages.<sup>64</sup>

In *Fidler v. Sun Life Assurance Co.*, McLachlin C.J.C. and Abella J., in jointly authored reasons, noted that "*Hadley v. Baxendale* makes no distinction between the types of loss that are

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<sup>59</sup> Cassels and Adjin-Tettey, *supra*, footnote 1, at pp. 39 and 29 (in the context of the sale of goods, again, under the heading of "lost profits and other consequential damages").

<sup>60</sup> *Canlin*, *supra*, footnote 24, at para. 12.

<sup>61</sup> *Fidler*, *supra*, footnote 18, at para. 54.

<sup>62</sup> *Sharab Developments Ltd. v. Zellers Inc.*, 1999 BCCA 39 (B.C. C.A.), leave to appeal refused (2000), 227 W.A.C. 212 (note) (S.C.C.).

<sup>63</sup> *Atos IT* (Ont. S.C.J.), *supra*, footnote 42, will be discussed in detail below.

<sup>64</sup> *Atos IT* (Ont. S.C.J.), *supra*, footnote 42, at paras. 356-361. The trial judge's interpretation of the exclusion clause in this contract, and his conclusion that lost profits on the fixed price services subcontract were direct losses were affirmed by the Ontario Court of Appeal, *Atos IT* (Ont. C.A.), *supra*, footnote 42, at paras. 85-87.

recoverable for breach of contract.”<sup>65</sup> The court’s focus in *Fidler* was on what losses were in the reasonable contemplation of the parties (*i.e.*, what was both presumed to be foreseeable and in their reasonable expectations) as a general principle governing whether a particular kind of damages would be recoverable (in this case, damages for mental distress).<sup>66</sup> However, later, in *RBC Dominion Securities v. Merrill Lynch Canada Inc.*, McLachlin C.J.C. and Abella J. appeared to take slightly different courses on damages, including lost profits.<sup>67</sup> The Chief Justice (as McLachlin was then), writing for the majority, focused on foreseeability in allowing the plaintiff’s claim for lost profits over a five-year post-breach period. In her view:

The correct question to ask is whether, had the parties at the time of entering into the contract . . . directed their minds to the possibility [of the breach], would they have contemplated a loss of profits giving rise to damages.<sup>68</sup>

In contrast, Abella J. dissented and denied RBC’s claim for five years’ lost profits. In her reasons, she focused on reasonable expectations as a governing, and limiting, principle in the recovery of lost profits. In her view, the parties’ reasonable expectations, in the context of the particular contract and industry, are the key to determining whether lost profits were foreseeable and recoverable under *Hadley*.<sup>69</sup>

A court must ask itself “what was in the reasonable contemplation of the parties at the time of contract formation.”

The principle of remoteness “imposes on damages awards reasonable limits which are required by fairness”. It aims to “prevent unfair surprises to the defendant, to ensure a fair allocation of the risks of the transaction, and to avoid any overly chilling effects on useful activities by the threat of unlimited liability”. This principle will be informed by the nature and culture of the business in question, and the particular contractual relationship between the parties.

Justice Abella’s reasons identify one of the principal issues that must be confronted in determining whether damages will be awarded for lost profits. Courts and writers have attempted to impose various limits on the kinds of damages that may be recovered, including lost profits. Foreseeability in this context is limited by the concept of remoteness. At what point a plaintiff’s losses become remote, however, may be unclear. Some look to causal connections to determine which losses naturally arise from a breach and which arise as a subsequent consequence of it. The further away from the immediate breach, and the further down the causal chain of events the loss occurred, the less compelling the claim for damages becomes. Others have suggested, as does Abella J., that there must be some limitation of the defendant’s exposure to liability based on reasonableness in light of the benefits of the contract, in addition to other limiting factors, such as remoteness and proximity. This is especially relevant to claims for lost profits, which have been treated variously as falling under both the First and Second Branches.

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<sup>65</sup> *Fidler*, *supra*, footnote 18, at para. 30.

<sup>66</sup> *Fidler*, *supra*, footnote 18, at para. 27 (quoting *Hadley*, that “these damages must be ‘such as may fairly and reasonably be considered either arising naturally . . . from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties’”).

<sup>67</sup> *RBC Dominion Securities Inc. v. Merrill Lynch Canada Inc.*, 2008 SCC 54 (S.C.C.).

<sup>68</sup> *RBC Dominion Securities v. Merrill Lynch Canada Inc.*, *supra*, footnote 67, at para. 12.

<sup>69</sup> *RBC Dominion Securities v. Merrill Lynch Canada Inc.*, *supra*, footnote 67, at paras. 63-64 (citations omitted).

Whether the contracting parties, or a judge, consider lost profits to be recoverable damages will depend on how they conceive of and apply such limits to those losses in the context of a particular contract and breach. The Supreme Court of Canada has affirmed that losses must first have been in the reasonable contemplation of the parties (*i.e.*, foreseeable) in order to be recoverable. Whether lost profits were foreseeable to the parties is a question of fact. For example, in *General Refractories Co. of Canada v. Venturedyne Ltd.*, the plaintiff bought a modified design friction press to manufacture bricks.<sup>70</sup> The press never worked because the modifications made to meet the buyer's requirements were negligently designed. The Ontario Superior Court concluded that the buyer was entitled to recover losses that were the "direct and natural consequences of the breach", which included damages for:

- the purchase price;
- set-up and installation;
- repair costs, including wages and salaries;
- material costs for mix wasted in the press; and
- tear-down costs.

However, while the court concluded that the plaintiff's lost profits would have been recoverable, the buyer had no evidence that they were foreseeable at the time it entered into the contract. In fact, the buyer's own expectation was that it would not make money from the new press for years.<sup>71</sup>

The problem is that a court's role in determining whether losses are direct or "consequential" damages is not always so factually driven and is, at times, normative. In some cases, it will be relatively obvious what damages will arise in the ordinary or "usual course of things". In other cases, however, why a court has concluded that certain damages are "objectively" foreseeable and are thus direct damages is more elusive. The inquiry into what the parties *ought* to have foreseen is open to the criticism that the legal analysis in any given case is results-driven: the court concludes that the seller and not the buyer, or vice versa, should bear the risks associated with the breach. Where damages are awarded despite the seller's attempt to contractually exclude liability for lost profits, it is fair to wonder if the court tipped the scale in the plaintiff's favour based on its assessment of the proper or reasonable allocation of risk between the parties.<sup>72</sup>

This problem arises in part because, as noted by the Ontario Court of Appeal in *Kienzle v. Stringer* and the Supreme Court of Canada in *Fidler v. Sun Life Assurance Co.*, "reasonableness" is a governing principle in damages, and determining what losses were within the *reasonable* contemplation of the parties is not purely fact driven. What is reasonable is ultimately determined by the courts. Indeed, the Ontario Court of Appeal was very forthright in acknowledging that what damages ought to be reasonably foreseen or reasonably contemplated as a direct and natural consequence is essentially a policy decision, stating "[t]hese terms necessarily include more policy

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<sup>70</sup> *General Refractories Co. of Canada v. Venturedyne Ltd.*, 2002 CarswellOnt 36 (Ont. S.C.J.).

<sup>71</sup> *General Refractories Co. of Canada v. Venturedyne Ltd.*, *supra*, footnote 70, at paras. 223 and 226.

<sup>72</sup> See *e.g.*, *Synchrude*, *supra*, footnote 49.

than fact as courts attempt to find some fair measure of compensation to be paid to those who suffer damages by those who cause them.”<sup>73</sup>

Moreover, as Rix J. pondered in *BHP Petroleum*, how is the trier of fact to meaningfully distinguish between what the parties ought to have known and what they actually knew because of their negotiations?<sup>74</sup> The court’s inquiry must focus on the factual matrix in which the contract was made, which will include evidence of the course of negotiations between the parties and the allocation of risk between them. But what kind of evidence will suffice to show that special circumstances were communicated by the buyer to the seller and that the seller accepted an extraordinary risk? Isn’t the fact that a seller negotiated a warranty and an exclusion of liability for consequential damages (which included lost profits) evidence that the seller was not prepared to accept extraordinary risks or any liability beyond the negotiated warranty?

And, in many cases, courts seem to readily award damages for lost profits, even where consequential damages are excluded, on the grounds that they are the direct and natural result of a breach and thus recoverable under the First Branch. Business transactions, whether for the purchase of equipment or a corporate entity, are entered into with each party hoping to gain financial benefit. The seller’s benefit is immediate. The buyer, however, obviously hopes to eventually enjoy some return on the investment it made in acquiring the asset. Equipment is used to make products or perform services that can be sold. Corporations are bought for their current and future revenue streams or possibly enhanced efficiencies when the acquired business is combined with the buyer’s existing operations. In some respects, it is always foreseeable that the buyer will lose revenue or profits if it does not receive what it bargained for.

In this sense, lost profits damages protect parties’ expectation interests the same as any other kind of damages. Contract law, it has been observed, promotes commerce because it allows parties to rely on their bargain and the other party’s future performance of its side of the deal. Parties are incentivized to honour their bargains because, if they don’t, the courts will enforce them by compensating an innocent party not just for out-of-pocket expenses but also for their reasonably expected economic benefits.<sup>75</sup> This is important because in many cases the expectation of profit is the whole object of the contract, whether in the context of the sale of goods, the delivery of services, or the purchase of a business.

## VII. DRAFTING TO AVOID (OR PERMIT) CLAIMS FOR LOST PROFITS

If there is no other point taken from this article, it is that lost profits are not consequential damages; or at least, not always. While lost profits are commonly seen as a kind of consequential damage (falling under the Second Branch), in reality lost profits can also be direct losses falling under the First Branch. Accordingly, deal lawyers must be wary in relying on boilerplate language, and should actually *draft* the limitations and exclusion clauses to specifically address the allocation of risk for the buyer’s lost profits in the event of the seller’s breach of contract. Counsel to a seller must be aware that lost profits *can* be direct damages under the First Branch and will not necessarily be excluded by exclusion clauses that target consequential damages or other commonly

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<sup>73</sup> *Kienzle v. Stringer* (1981), 35 O.R. (2d) 85, 1981 CarswellOnt 530 (Ont. C.A.), at para. 21 (citation omitted).

<sup>74</sup> *BHP Petroleum*, *supra*, footnote 21, at p. 567.

<sup>75</sup> Waddams, *Contracts*, *supra*, footnote 16, at para. 703.

associated terms. There is ample support for this conclusion in numerous Canadian cases,<sup>76</sup> as well as a series of English cases from the late 1990s, which strongly support the view that lost profits, along with the costs of remediation, reconstruction and lost overhead are almost invariably direct damages under certain circumstances.<sup>77</sup> Conversely, counsel to a buyer must be aware that waiving consequential damages may leave its client without the ability to recover a significant portion of its losses in the event of the seller's breach, depending on how that term is defined by the agreement and, ultimately, by a judge.

## 1. Where Lost Profits Have Been Recoverable

In *Atos IT Solutions and Services GMBH v. Sapient Canada Inc.*, the Ontario Superior Court awarded damages that included lost profits despite the fact that an exclusion clause in the parties' agreement specifically excluded lost profits. The plaintiff, a division of Siemens, claimed damages on the basis that Sapient breached its subcontract to perform a two-phase project. The first phase was improperly terminated three weeks prior to the completion of the work. As a result, Siemens did not get to perform the second phase of the subcontract, which would have involved providing ongoing services.<sup>78</sup>

Justice Pattillo began his analysis with the basic proposition that Siemens was entitled to damages based on its actual losses resulting from the breach, measured by its expectation interest. In a service contract, this included lost profits. The proper measure of damages for the first phase, where Siemens had been unpaid for months for work it had completed, was the balance owing under the contract.<sup>79</sup> No work had been done on the second, service phase of the contract so the proper measure of damages was the profits that Sapient would not earn because of its improper termination.<sup>80</sup>

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<sup>76</sup> *Freedhoff*, *supra*, footnote 48; *Synchrude*, *supra*, footnote 49; *Ticketnet* (Ont. Gen. Div.) *supra*, footnote 48. The difference between direct and indirect damages was also notably discussed by the New York Court of Appeal in *Biotronik v. Conor Medsystems Ireland Ltd.* (22 N.Y.3d 799 (2014)). The court's analysis is consistent with the common law conception of damages in Canada, and with the two heads of damages recognized in *Hadley v. Baxendale*. While the appellate court allowed the plaintiff's claim for lost profit as a form of direct damages, the case illustrates the cases where lost profits are direct damages and when they are consequential damages. General damages "are the natural and probable consequence of the breach" of a contract. They include "money that the breaching party agreed to pay under the contract." By contrast, consequential, or special, damages do not "directly flow from the breach." "The distinction between general and special damages in contract is well defined, but its application to specific contracts and controversies is usually more elusive". Lost profits may be either general or consequential damages, depending on whether the non-breaching party bargained for such profits and they are "the direct and immediate fruits of the contract." Otherwise, where the damages reflect a "loss of profits on collateral business arrangements", they are only recoverable where "(1) it is demonstrated with certainty that the damages have been caused by the breach (2) the extent of the loss is capable of proof with reasonable certainty, and (3) it is established that the damages were fairly in the contemplation of the parties." [Citations omitted.]

<sup>77</sup> The Court of Appeal of England and Wales illustrates not only the shifting sands in characterising losses as direct or consequential losses, but also the value in specifically excluding lost profits in order to mitigate risk. In *Deepak*, *supra*, footnote 38, at p. 31, the Court of Appeal considered the following exclusion clause:

. . . and in no event shall Davy by reason of its performance or obligation under this contract be liable in tort or for loss of anticipated profits, catalyst, raw material and products or for indirect and consequential damages.

The plaintiff operated a methanol plant that was destroyed by a fire and sought to recover damages for fixed costs and overhead for the time between the explosion and when the plant resumed production. The trial judge excluded all heads of damages, other than those incurred to rebuild the plant. These excluded losses included overhead, lost profits and additional materials. The Court of Appeal concluded that the trial judge erred in holding that only the costs of rebuilding the damaged plant were recoverable. While lost profits were expressly excluded (and therefore not recoverable), the court concluded that both fixed costs and overhead were direct losses because they were no more remote than the costs of reconstruction. This view is in direct contrast with the characterization of consequential damages, which would seem to obviously include lost profits. *Deepak*, *supra*, footnote 38, at para. 90.

<sup>78</sup> *Atos IT* (Ont. S.C.J.), *supra*, footnote 42.

<sup>79</sup> *Atos IT* (Ont. S.C.J.), *supra*, footnote 42, at para. 325-326.

<sup>80</sup> *Atos IT* (Ont. S.C.J.), *supra*, footnote 42, at para. 324.

The next question was whether the parties excluded or limited their respective liability for lost profits. The defendant argued that it was not liable for lost profits, relying on the subcontract's limitation of liability, which provided:<sup>81</sup>

18.6.1. SUBJECT TO SECTION 18.6.2, NOTWITHSTANDING ANYTHING TO THE CONTRARY HEREIN, EACH OF SUBCONTRACTOR AND SAPIENT WILL BE LIABLE TO THE OTHER WITH RESECT TO THIS AGREEMENT AND ANY OTHER OBLIGATIONS RELATED THERETO ONLY FOR DIRECT DA- MAGES . . .

. . . . .

FOR GREATER CERTAINTY, SUBJECT TO SECTION 18.6.2, NEITHER SUBCONTRACTOR NOR SAPIENT WILL BE LIABLE TO THE OTHER TO THE OTHER FOR INDIRECT, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES OR FOR LOSS OF PROFITS (COLLECTIVELY, "EXCLUDED DAMAGES"), EVEN IF THE PARTY HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES.

Section 18.6.2 provided that the limitation of liability applied to any claim, irrespective of the nature of the cause of action. The specific mention of lost profits, not as an example of consequential damages, but on its own (using "or" and not "including but not limited to" or "such as") may have been considered sufficient to exclude liability for these damages. The trial judge rejected this argument, however,<sup>82</sup> noting that from the outset Siemens was entitled to recover its direct losses measured by its expectation in the performance of the contract, and lost profits were a form of direct damages. The parties agreed that they were liable to each other for recovery for direct damages. Mentioning "lost profits" as excluded damages did not change this arrangement.<sup>83</sup>

Given the above grouping and inclusion of "loss of profits" as Excluded Damages along with "indirect, special and consequential damages," in my view the reference to "loss of profits" in Section 18.6.1 refers to consequential or indirect lost profits, *i.e.*, a breach that causes either Siemens or Sapient to lose profit from other work foregone as a result of the breach. Consequential lost profits do not include profits under the Subcontract but rather are indirect losses which are only recoverable when they are foreseeable or communicated to the defendant: *Hadley v. Baxendale* [citation omitted]. My conclusion that the provision of "loss of profits" in Excluded Damages relates to consequential or indirect profits is further confirmed by the concluding words of the paragraph which provide: "even if the party has been advised of the possibility of such damages." That language is in accordance with the *Hadley* recovery principle for consequential damages.

Sapient appealed this decision to the Ontario Court of Appeal. While the court varied the trial judge's determination of damages under the first phase of the subcontract, it left intact his

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<sup>81</sup> *Atos IT* (Ont. S.C.J.), *supra*, footnote 42, at para. 351 (emphasis in original).

<sup>82</sup> As discussed below, it has been suggested by some commentators and practitioners that specifically excluding lost profits (and not simply including lost profits as a form or example of consequential loss) may clarify that the parties intended to exclude liability for all lost profits, whether they are direct or consequential losses.

<sup>83</sup> *Atos IT* (Ont. S.C.J.), *supra*, footnote 42, at para. 358.

interpretation of the exclusion clause. Finding that this interpretation attracted a deferential standard of review, the court found that the trial judge’s interpretation had no “extricable errors of law or palpable and overriding errors of fact” and, as such, Sapien’s mere disagreement could not justify appellate intervention.<sup>84</sup> As the Court of Appeal concluded (and herein lies the difficulty for deal lawyers) “[r]easonable people can disagree about the meaning of some contractual provisions” and that *Sattva* is premised on “the inevitability of reasonable disagreement about the interpretation of provisions in a non-standard contract.”<sup>85</sup>

More recently, the Alberta Court of Queen’s Bench reached a nearly identical conclusion on the basis of a similar exclusion clause in *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*. The parties’ dispute centred on the operation of an ethylene production facility owned as a joint venture but operated by NOVA. Dow Chemical alleged that NOVA had breached the co-ownership and operations agreements by operating the facility in its own interests as a competitor. In addition to substantive and limitations defences, NOVA also argued that exclusion clauses in the agreements shielded it from liability. These clauses provided that the parties would not be liable to each other for “Excluded Damages”, defined in both agreements as:<sup>86</sup>

(i) indirect or consequential damages (including without limitation loss of profits and damages arising from loss of production) ... and (ii) loss of or damage to the Plant or the Products.

Following a line of English cases, Romain J. held that lost profits could be both direct or consequential damages depending on the context and interpreted the clause as only excluding lost profits that were otherwise consequential losses but not those which were direct losses.<sup>87</sup> She further held that the parties must have foreseen that under-production at the facility — the “under-delivery of a saleable product” — could result in lost profits.<sup>88</sup> This was not only objectively foreseeable, but would have been evident to NOVA as the parties were in the same business.<sup>89</sup> As such, Dow Chemical’s claimed damages for lost profits and lost production were not excluded and NOVA was ultimately found liable.<sup>90</sup>

Another recent case is the Ontario Superior Court’s decision in *Human Logistics v. PAL Airlines* in which the plaintiff sought liquidated damages and lost profits for breach of restrictive covenants in a carrier transportation agreement.<sup>91</sup> As a preliminary issue to the ultimate issue of liability, Ferguson J. considered whether an exclusion clause in the agreement barred the plaintiff’s claims. Amongst other terms governing the defendant’s liability, the provision expressly excluded liability for:<sup>92</sup>

.....any consequential or special damages or losses including loss of profit or anticipated profit arising from its performance of or failure to perform the Flights

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<sup>84</sup> *Atos IT* (Ont. C.A.), *supra*, footnote 42, at paras. 83-87.

<sup>85</sup> *Atos IT* (Ont. C.A.), *supra*, footnote 42, at paras. 86-87.

<sup>86</sup> *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*, 2018 ABQB 482 (Alta. Q.B.), at paras. 995-999.

<sup>87</sup> *Dow Chemical Canada ULC v. NOVA Chemicals Corp.*, *supra*, footnote 86, at paras. 1032-1034.

<sup>88</sup> *Dow Chemical Canada ULC v. NOVA Chemicals Corp.*, *supra*, footnote 86, at para. 1035.

<sup>89</sup> *Dow Chemical Canada ULC v. NOVA Chemicals Corp.*, *supra*, footnote 86, at paras. 1035-1036.

<sup>90</sup> *Dow Chemical Canada ULC v. NOVA Chemicals Corp.*, *supra*, footnote 86, at paras. 1037 and 1175-1176. Nova Chemical has appealed the decision to the Alberta Court of Appeal, including Romain J.’s interpretation of “Excluded Damages” in the agreements: *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*, 2018 ABQB 482 (Alta. Q.B.), Calgary, ABCA 1801-00226 (Notice of Civil Appeal).

<sup>91</sup> *Human Logistics v. PAL Airlines*, 2018 ONSC 7433 (Ont. S.C.J.).

<sup>92</sup> *Human Logistics v. PAL Airlines*, *supra*, footnote 91, at para. 166.

or any of its obligations under this Agreement whether or not Carrier was negligent or has or should have had knowledge that such damage or loss might be sustained.

Ferguson J. found that, while the wording of the clause blurred the intention of the agreement with its references to airline tariffs and an international convention dealing with the rights and obligations of airlines and customers, when “read in context with the intention, purpose and factual matrix of the [agreement]” it did not exclude the plaintiff’s claims.<sup>93</sup> It only limited liability for personal injury to passengers and damage to baggage or cargo when providing services under the agreement. The damages claimed by the plaintiff and counterparty, a third-party broker, were “direct or actual damages... caused by a breach of the [agreement] itself” not excluded by the clause.<sup>94</sup> As a result, while the claim for liquidated damages was denied on the basis that they were not a genuine pre-estimate of damages, the plaintiff was entitled to damages for its lost profits.<sup>95</sup>

Although these are some of the latest statements from Canadian courts on this issue, it is important to note that this view is not universal within Canada or other common law jurisdictions; as we discussed above, the Commercial Court of England and Wales came to the opposite conclusion in its 2016 decision in *Star Polaris*. There the court rejected the idea that such language would only exclude lost profits falling under the Second Branch, but not lost profits that were direct losses.<sup>96</sup>

## 2. Where Lost Profits Have Been Excluded

There is also some Canadian judicial support for the view that lost profits are consequential losses — *i.e.*, not direct damages. Despite making a great deal of common sense, however, the precedent is of limited weight and there is no clear appellate authority that lost profits, by their nature, are not losses flowing from the immediate results of the breach of contract. These cases offer some hope for litigators, but should be seen by deal lawyers as offering limited comfort to a seller that wants to exclude liability for lost profits.

*Agfaphoto Canada Inc. v. Overwaitea Food Group Ltd.*<sup>97</sup> stands out as one of very few decisions where a court viewed consequential losses in a way that would make sense to most business people. This British Columbia Supreme Court decision, however, has received limited judicial consideration.

Overwaitea claimed damages (by way of set off) for the early termination of a series of agreements relating to in-store photo “mini-labs”. It claimed lost profits due to Agfaphoto’s failure to supply goods in a timely manner and for Agfaphoto’s supplying defective goods.<sup>98</sup> Agfaphoto argued that Overwaitea’s claim for lost profits was contractually excluded under their supply agreement, which provided:<sup>99</sup>

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<sup>93</sup> *Human Logistics v. PAL Airlines*, *supra*, footnote 91, at paras. 173-174.

<sup>94</sup> *Human Logistics v. PAL Airlines*, *supra*, footnote 91, at paras. 174-176.

<sup>95</sup> *Human Logistics v. PAL Airlines*, *supra*, footnote 91, at para. 199.

<sup>96</sup> *Star Polaris LLC*, *supra*, footnote 40.

<sup>97</sup> *Agfaphoto*, *supra*, footnote 27.

<sup>98</sup> *Agfaphoto*, *supra*, footnote 27.

<sup>99</sup> *Agfaphoto*, *supra*, footnote 27, at para. 21.

## 25. Limitation of Liability

The Buyer agrees that in no event will the Seller or Seller's affiliates be liable to the Buyer or anyone else for loss of profit, indirect, special, punitive or consequential damages arising out of any breach of the Agreement, or arising out of the sale, use or improper functioning of the Equipment, including, without limitation: Loss of profit, goodwill or revenue: business interruption: even where caused by the negligence of the Seller or that of its affiliates. In no case shall the Seller or Seller's affiliates liability exceed the price paid to the Seller by the Buyer for the Equipment at issue.

Overwaitea argued that clause 25 did not apply to its claim for lost profits as the parties had intended to limit only claims for indirect or consequential damages, and not damages flowing naturally from the breach. It said its lost profits were direct damages and were not consequential losses excluded by clause 25.<sup>100</sup> The court rejected Overwaitea's characterization of lost profits as "direct damages". Noting the line of English authority holding that lost profits are recoverable as direct damages, Holmes J. observed, but without citing any jurisprudence, that this view was not shared in the Canadian law of contract damages. He explained as follows:<sup>101</sup>

The established approach is reflected, for example, in the following passages from *McGregor on Damages* with which *British Sugar* . . . expressly disagreed, and John Swan, *Canadian Contract Law*:

. . . in contract, where pecuniary losses are nearly ubiquitous, another distinction is taken and built upon. This is the useful and important division between normal and consequential losses. The normal loss is that loss which every Plaintiff in a like situation will suffer; the consequential loss is that loss which is special to the circumstances of the particular Plaintiff. In contract the normal loss can generally be stated as the market value of the property, money or services that the Plaintiff should have received under the contract less either the market value of what he does receive or the market value of what he would have transferred but for the breach. *Consequential losses are anything beyond this normal measure, such as profits lost or expenses incurred through the breach, and are recoverable if not too remote. McGregor, as cited in British Sugar.*

One is likely to encounter in many kinds of agreements a distinction between "direct" and "indirect" damages, and descriptions of the latter as "consequential" or "incidental". In a contract of sale, the seller may agree to be liable for "direct" damages but not for "indirect" or "consequential" damages. It is convenient to adopt a usage that corresponds to that frequently used by solicitors and by the courts . . . The terms "consequential", "incidental" and "indirect" damages refer to damages that

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<sup>100</sup> *Agfaphoto, supra*, footnote 27, at paras. 22-23.

<sup>101</sup> *Agfaphoto, supra*, footnote 27, para. 25 (citations omitted) (emphasis added).

are in *addition to or that arise as a consequence of the direct damages of the promisor's breach.* *Swan.*

The Ontario Superior Court reached the same conclusion in *Schenker of Canada Ltd. v. Royal King Upholstery Inc.* In this case, a freight forwarder relied on a waiver that provided that “Schenker shall not be liable for consequential damages, including ... claims for... loss of profits or revenue ... fixed or variable costs ... “ as a defence to the defendant’s counterclaim for damages.<sup>102</sup> The defendant, Royal King Upholstery Inc., was a furniture distributor and its goods were held by the plaintiff during a dispute over payment for freight services, customs duties and other charges. The distributor sought damages for lost profits on goods that were damaged after being dropped from a crane and other goods that were detained due to non-payment and later found to be damaged.<sup>103</sup> The judge found no evidence to support the defendant’s counterclaim for lost profits and overhead expenses related to either incident, but still noted in *obiter* that such losses would be barred by the exclusion clause in the plaintiff’s standard terms and conditions.<sup>104</sup>

More recently, in *MediaLinx Printing Ltd. v. United Parcel Service Canada Ltd.*, the Ontario Superior Court dealt with another exclusion clause and found that it did apply to exclude lost profits but based on contractual interpretation, not the classification of damages. This decision was on a motion for summary judgment. The plaintiff sought lost profits for breach of a software licensing agreement and other damages that arose when the defendant’s software stopped applying the plaintiff’s mark-up to shipping rates processed using the software.<sup>105</sup> The defendant’s principal defence was that the plaintiff’s claim was precluded by an exclusion and limitations clause in the agreement which stated that:<sup>106</sup>

[The defendant,] ITS AGENTS AND SUPPLIERS SHALL IN NO EVENT BE LIABLE TO CUSTOMER FOR ANY DAMAGES, INCLUDING ANY INDIRECT, INCIDENTAL, OR CONSEQUENTIAL DAMAGES, LOST PROFITS OR DAMAGED DATA, LOST SAVINGS OR OTHER SUCH DAMAGES ARISING OUT OF THE POSSIBILITY OF SUCH DAMAGES, REGARDLESS OF THE FORM OR CAUSE OF ACTION, WHETHER IN CONTRACT OR IN TORT, INCLUDING NEGLIGENCE OR FOR ANY CLAIM BY ANY OTHER PERSON OR ENTITY.

The judge in this case found that the clause was applicable and barred the plaintiff’s claim without any discussion of the different kinds of damages. Instead, she gave the clause its “‘natural and true construction’ based on the ordinary and grammatical meaning of the words used”.<sup>107</sup> As it was not unconscionable or commercially unreasonable, nor was there any overriding public

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<sup>102</sup> *Schenker of Canada Ltd. v. Royal King Upholstery Inc.*, 2010 ONSC 1821 (Ont. S.C.J.), at para. 85.

<sup>103</sup> *Schenker of Canada Ltd. v. Royal King Upholstery Inc.*, *supra*, footnote 102, at paras. 1 and 20.

<sup>104</sup> *Schenker of Canada Ltd. v. Royal King Upholstery Inc.*, *supra*, footnote 102, at paras. 78-85 and 104-105. See also *Linde Canada Ltd. v. Luff Industries Ltd.*, 2016 ABQB 298 (Alta. Q.B.), at para. 50. In this case, the supply contract between the parties included an exclusion of all liability (whether in contract, tort or strict liability, etc.) for “indirect, special, incidental, exemplary, consequential damages or economic loss, including any loss of business, production, or profits”. *Supra*, at para. 50. The buyer conceded that the exclusion applied to its claim, but argued that it would be unconscionable to enforce it. Following *Tercon*, *supra*, footnote 6, the court concluded that “[s]tep one is to determine if the exclusion clause applies to the circumstances. Regardless of Luff’s concession I am satisfied that as a matter of law it does.” The clause was not unconscionable, nor was there any public policy justification in refusing to enforce it. *Supra*, at paras. 54-61.

<sup>105</sup> *MediaLinx Printing Ltd. v. United Parcel Service Canada Ltd.*, 2018 ONSC 2946 (Ont. S.C.J.).

<sup>106</sup> *MediaLinx Printing Ltd. v. United Parcel Service Canada Ltd.*, *supra*, footnote 105, at para. 10.

<sup>107</sup> *MediaLinx Printing Ltd. v. United Parcel Service Canada Ltd.*, *supra*, footnote 105, at para. 47.

policy concern, there was no reason not to apply the clause.<sup>108</sup> Justice Nishikawa thus dismissed the plaintiff's claims and granted the defendant's counterclaim for unpaid invoices.<sup>109</sup>

An exclusion clause was also found to preclude recovery of lost profits in *Montrose Hammond & Co. v. CIBC World Markets Inc.* for very similar reasons. In that case, the plaintiff hedge fund brought an action against CIBC for direct losses from error trades related to CIBC's market access services and lost profits for the subsequent failure of the hedge fund.<sup>110</sup> CIBC relied on the terms of its technology services agreements with the plaintiff and especially on their exclusion clauses. The first, part of the technology services agreement, was alleged to exclude all liability arising out of the agreement but was interpreted down so as to not exclude the plaintiff's claims.<sup>111</sup> The second was part of the brokerage services agreement and excluded: (i) all losses except those incurred by wilful misconduct, fraud or gross negligence; (ii) indirect or consequential losses; and (iii) losses from third-party actions, but the agreement was found not to apply to the case.<sup>112</sup>

The third exclusion clause, however, was the most important to the decision. It excluded CIBC from liability for "any indirect, incidental, special or consequential losses or damages (including, but not limited to, loss of profits or revenue or failure to realize expected profits or savings, or the avoidance of any losses) arising out of or related to this Agreement, the Systems Interconnect or use of the Trading System".<sup>113</sup> Penny J. found that the clause did not exclude the plaintiff's recovery of direct losses, but it did bar the plaintiff's claim for lost profits "on a plain reading", which was not affected by unconscionability or public policy.<sup>114</sup> In doing so, Penny J. notably distinguished *Atos IT Solutions and Services GMBH v. Sapient Canada Inc.* on the basis that the lost profits at issue here were "indirect" and "consequential" and the different wordings of the clauses between the two cases. On the latter point, Penny J. commented that:<sup>115</sup>

Here, the contract does not subsume the excluded lost profits within the concept of consequential loss. Rather, the excluded loss is specifically *defined* to include "loss of profits, or failure to realize expected profits."

The defendant, CIBC, was ultimately found liable for the plaintiff's direct trading losses;<sup>116</sup> this "plain" style of interpretation was determinative of the claim for lost profits just as it was in *MediaLinx Printing*.

While the judges in both cases believed that they were conducting straightforward interpretive exercises, Penny J's decision in *Montrose Hammond* is noticeably more involved. The clauses in *MediaLinx Printing* and *Montrose Hammond*, and their treatment of lost profits, were different; significantly so. The exclusion in *MediaLinx Printing* did not attempt to characterize the excluded losses generally, or lost profits specifically, as being either direct or consequential losses.

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<sup>108</sup> *MediaLinx Printing Ltd. v. United Parcel Service Canada Ltd.*, *supra*, footnote 105, at paras. 51, 55, 58-59.

<sup>109</sup> *MediaLinx Printing Ltd. v. United Parcel Service Canada Ltd.*, *supra*, footnote 105, at paras. 79-80.

<sup>110</sup> *Montrose Hammond & Co. v. CIBC World Markets Inc.*, 2019 ONSC 2870 (Ont. S.C.J. [Commercial List]), affirmed 2020 CarswellOnt 3697 (Ont. C.A.).

<sup>111</sup> *Montrose Hammond*, *supra*, footnote 110, at paras. 76-93.

<sup>112</sup> *Montrose Hammond*, *supra*, footnote 110, at paras. 95-96.

<sup>113</sup> *Montrose Hammond*, *supra*, footnote 110, at para. 99.

<sup>114</sup> *Montrose Hammond*, *supra*, footnote 110, at paras. 100-103.

<sup>115</sup> *Montrose Hammond*, *supra*, footnote 110, at paras. 104-106 (emphasis in original).

<sup>116</sup> *Montrose Hammond*, *supra*, footnote 110, at para. 131.

“[L]ost profits” were simply included in a list of the types of damages that were excluded under the contract. Therefore, it seems clear that the parties intended to exclude any lost profits, regardless of whether these losses were direct losses (*i.e.*, those falling into the First Branch) or special circumstances losses (*i.e.*, those falling into the Second Branch).

However, the exclusion clause in *Montrose Hammond* arguably did characterize lost profits as a kind of consequential (*i.e.*, indirect) loss. Lost profits were mentioned parenthetically in the clause: “any indirect, incidental, special or consequential losses or damages (including, but not limited to, loss of profits )” in a section headed: “No Consequential Damages”.<sup>117</sup> Justice Penny’s reasoning to distinguish *Atos IT Solutions* and bar the claim for lost profits is therefore curious. Justice Penny concluded that lost profits were not “subsume[d]” in the “concept of consequential loss” because he treated the parenthetical reference to them as defining the excluded indirect, incidental, special or consequential losses or damages. However, it is also possible to understand the reference as an example or subset of the consequential damages that were excluded — *i.e.*, consequential damages are excluded, including consequential lost profits. Accordingly, this construction does not indicate that the parties intended to exclude all lost profits as clearly as the clause in *MediaLinx Printing*. In *Montrose Hammond*, that intention more obviously comes from what follows in the parenthetical. The description of excluded lost profits and revenue was extensive — it covered virtually every conceivable form of profit or revenue that could be realized through the use of CIBC’s platform. Therefore, while the result in this case was likely correct given the parties’ allocation of risk, we do not think that the exclusion clause excluded all lost profits as clearly as it could.

## VIII. DRAFTING THE EXCLUSION CLAUSE

The cases discussed in this article demonstrate there is no presumption or rule in Canadian law that delineates the content of a “consequential damages” exclusion or defines lost profits as either direct or consequential (*i.e.*, indirect) damages. Deal lawyers in particular cannot rely on judicial interpretations of limitations or exclusion clauses to provide any certainty about whether their client’s, or their counterparty’s, lost profits or other financial losses would be direct losses or consequential losses or whether their boilerplate limitation of liability or exclusion clauses preclude claims for recovery of lost profits. This is because contracts can only be interpreted in light of the circumstances of the bargain (the factual matrix) and in a way that is consistent with the reasonable expectations of the parties, including the risks assumed by each in the event of a breach. Lawyers who use standardized language to limit or exclude liability and defer to the courts to define those terms and how they apply to a transaction will only expose their clients to deal risks that they may not have bargained for or willingly assumed in the particular circumstances. Decisions such as *Overwaitea* make clear that parties relying on boilerplate clauses and language to limit and exclude liabilities simply cannot know that their implied understanding of consequential damages or lost profits will be applied by courts.

In our view, the proper approach in any case will be for the court to look at the contract as a whole, in the absence of substantive clarity in the particular exclusion provision, to determine whether, when the parties used the term “consequential”, they intended to refer to damages under the Second Branch or used the term more broadly. The subject matter of the contract and the

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<sup>117</sup> *Montrose Hammond*, *supra*, footnote 110, at para. 99.

reasonable expectations of the parties in the bargain will play a large role in determining what losses were reasonably anticipated and whether an exclusion clause was intended to bar recovery of damages. A court must interpret the exclusion clause in light of other provisions of the contract relating to the allocation of risk and determine whether the clause applies to the particular breach or losses claimed and whether the parties allocated the risk of that breach or loss to exclude liability for some or all lost profits.

While lost profits were not at issue in the Alberta Court of Appeal's decision in *Syncrude Canada Ltd. v. Babcock & Wilcox Canada Ltd.*, the court's approach to considering whether diminution in value and additional fuel costs were recoverable losses is illustrative of how a court can characterize losses in ways that may surprise the seller. In that case, the court held that losses that would typically be thought of as consequential losses were recoverable despite a broadly worded consequential damages exclusion. Babcock & Wilcox agreed to build and supply three high-efficiency boilers to Syncrude based on specifications provided by Syncrude's consultants. The boilers were designed to withstand a specified air pressure but were not built to the right specifications. In the end, the boilers could not withstand the air pressure required to operate at high efficiency without the risk of imploding. Syncrude claimed damages not only for the cost of strengthening the boilers but also the diminution in value of the plant and the additional fuel costs due to their lower than anticipated efficiency.<sup>118</sup>

Babcock & Wilcox relied on a provision of its contract to exclude liability for all of Syncrude's losses except for the direct costs of strengthening the boilers. It stated:

49. CONSEQUENTIAL DAMAGES: The Subcontractor will not be liable in any event for loss of anticipated profits, loss by reason of plant shutdown, non-operation or increased expense of operation of other equipment, or other consequential loss or damages of any nature arising from any cause whatever.<sup>119</sup>

The Alberta Court of Appeal concluded that this provision did not apply to any of the other costs claimed by Syncrude because the boilers were not shut down; they just did not operate at full efficiency. Moreover, even if the clause applied, the losses were not excluded. The court noted that "a usual measure of direct damages for supply of defective work or materials is the difference in value between what was contracted for, and what was delivered. None of that is consequential damages."<sup>120</sup> Syncrude was entitled to recover the capitalized value of the extra operating expenses involved in the uneconomical but safe operation of the boilers.<sup>121</sup>

The result is that if a seller wants to exclude its risk of liability for specific damages, it should insist that those damages are specifically enumerated in its agreement with the buyer. Lost profits or any other foreseeable losses, such as overhead or revenue, that the seller wishes to exclude should be expressly identified and listed. Broader categories, such as consequential damages, may be used, but each item should be drafted as standalone exclusions rather than as

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<sup>118</sup> *Syncrude, supra*, footnote 49.

<sup>119</sup> *Syncrude, supra*, footnote 49, at para. 49.

<sup>120</sup> *Syncrude, supra*, footnote 49, at para. 50.

<sup>121</sup> *Syncrude, supra*, footnote 49, at paras. 50-52. The Court of Appeal found no error on the trial judge's assessment of losses, which were not based on actual losses, but the determination of what costs should have been incurred to mitigate these losses. Mitigation costs similarly did not fall within clause 49 as consequential damages and no deduction was made for these costs.

examples, subcategories or related forms of loss to direct courts to exclude those losses whether or not they are direct or consequential at law.

## IX. THE ROLE OF ACCEPTANCE OF RISK

While much of this article's discussion of consequential damages and the Second Branch of *Hadley* has focused on foreseeability, before concluding, it is important to note that liability under this branch is not imposed solely on this basis. If extraordinary risks arose in special circumstances foreseen by the parties, a seller would only be liable to the extent that it accepted these risks.<sup>122</sup> In order to find that damages are recoverable under the Second Branch, a court must determine not only that the plaintiff gave the defendant notice of the special circumstances that made its damages reasonably foreseeable, but also that the defendant expressly or implicitly accepted the risk of liability arising from these special circumstances.

In any deal, the parties' matrix for determining what risks are acceptable, and how to mitigate unacceptable risks will be nuanced. Whether a seller accepts a foreseeable risk may depend on a number of factors, including the possible magnitude of damages, the anticipated benefit of the bargain, as well as the probability of occurrence and possible causation. Even significant financial risks may be acceptable if they are extremely unlikely to occur.

The best evidence of the risks that the parties accepted will be determined objectively from the agreement itself. The combination of warranty, indemnity, damages caps, as well as exclusion and limitation provisions and the use of any insurance must be read together to determine what risks the parties foresaw and accepted.<sup>123</sup> Where sophisticated parties negotiate a complete contractual code to allocate risks and apportion responsibility for damages, courts will be more inclined to give effect to the bargain struck by the parties, even if the parties define terms with different meanings than they would ordinarily have at law, for example, defining consequential damages to include losses that would normally fall within the First Branch.<sup>124</sup> This is precisely why relying on boilerplate provisions can be so hazardous. Boilerplate exclusions may suggest to a court that a seller accepted any risks that do not fit into the standard terms used. If there is evidence that the special circumstances were also communicated to the seller and it did nothing else to exclude or limit its liability for these risks, then they will likely be found liable. At best, boilerplate will fail to capture what losses the parties actually foresaw and which risks were accepted.

Careful attention should be paid to how the various clauses directed at mitigating or allocating risk work together. Exclusion and limitation clauses may be interpreted against the seller, and any ambiguity created by these different provisions will expose the seller to unanticipated risks. If a warranty is provided, for example, it should state that all liability ends when the warranty expires. Otherwise, a court will be invited to consider that the seller accepted additional risk and liability, regardless of an otherwise tight and limited warranty.

In the case of lost profits, the fact that the parties devoted time to negotiate risk mitigation should be evidence that: (i) the parties foresaw the risk of lost profits (whether under the First

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<sup>122</sup> Swan and Adamski, *supra*, footnote 2, at pp. 512-513.

<sup>123</sup> See, e.g., *New Brunswick Power*, *supra*, footnote 10; *Star Polaris LLC*, *supra*, footnote 40; *Transocean*, *supra*, footnote 39.

<sup>124</sup> See *Star Polaris LLC*, *supra*, footnote 40; *Transocean*, *supra*, footnote 39; *Agfaphoto*, *supra*, footnote 27.

Branch or Second Branch); and (ii) the seller did not accept the risk of significant damages claims for lost profits beyond any warranty it provided. There are a handful of cases to support this perspective in which courts have recognized that few sellers are prepared to accept a risk that their potential liability will exceed their expected economic benefit of the bargain. These cases are not decided on whether special circumstances were communicated or the foreseeability of the risk of lost profits, but rather on the seller's unwillingness to accept the risk of liability for losses extending beyond the immediate effects of the breach of contract and the warranty it offered to the buyer.<sup>125</sup> This kind of extensive risk is not commercially reasonable in most circumstances, even if the risk is reasonably foreseeable.

The unwillingness of a seller to accept the risk of lost profits was determinative for Sharpe J. (as he then was) in *TransCanada Pipeline Ltd. v. Solar Turbines Inc.* In that case, the seller, Solar, honoured the warranty it provided to TransCanada and paid for repairs to defective equipment it sold. TransCanada recovered a portion of its lost profits under business interruption insurance. Its insurer then asserted a subrogated claim against Solar for the amounts it paid to TransCanada under the policy.<sup>126</sup> The contract negotiated by Solar and TransCanada contained a limitation of liability provision which provided in part:<sup>127</sup>

In no event, whether as a result of breach of contract or warranty or alleged negligence or liability without fault or any other liability, shall the seller be liable for incidental, consequential, indirect, special or punitive damages which shall include without limitation loss of goodwill, loss of profits or revenue, loss of the use of the equipment, cost of capital, cost of substituted equipment and part, facilities or services, downtime costs, labour costs, or claims whether in contract negligence or any other liability.

Justice Sharpe found that the seller's evidence, including the limitation clause, established that Solar "consistently took the position that it would not assume liability for incidental or consequential damages resulting from the loss of use of the equipment or loss of profits."<sup>128</sup> Throughout negotiations, Solar had insisted that the contract contain a provision which provided that the "Seller shall not be liable to buyer for any incidental or consequential damages including but not limited to loss of product, loss of profits, loss of use, whether in contract or in negligence."<sup>129</sup> TransCanada's witness testified that in his experience, he had never dealt with a supplier that was going to accept liability for consequential damages, as "the risk was simply too great".<sup>130</sup>

Taking into account the factual matrix, including the history of negotiations between the parties, Sharpe J. dismissed the claim.<sup>131</sup>

In my view, the defendant has shown beyond any serious doubt that to give commercial reality to the bargain that was struck between these parties and to give

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<sup>125</sup> This was noted by the New Brunswick Court of Appeal in *New Brunswick Power*, *supra*, footnote 10, at p. 38.

<sup>126</sup> *TransCanada Pipelines Ltd. v. Solar Turbines Inc.*, 1998 CarswellOnt 4288 (Ont. Gen. Div.).

<sup>127</sup> *TransCanada Pipelines Ltd.*, *supra*, footnote 126, at para. 16.

<sup>128</sup> *TransCanada Pipelines Ltd.*, *supra*, footnote 126, at para. 7.

<sup>129</sup> *TransCanada Pipelines Ltd.*, *supra*, footnote 126, at para. 8.

<sup>130</sup> *TransCanada Pipelines Ltd.*, *supra*, footnote 126, at para. 11.

<sup>131</sup> *TransCanada Pipelines Ltd.*, *supra*, footnote 126, at para. 21.

proper effect to their contractual intent that was demonstrated both by their words and by their conduct both before and after the agreement of September 4th was signed, the only conclusion possible is that the September 4th, 1990, agreement was not exhaustive of the rights and obligations with respect to Solar Inc.; and that the plaintiff did agree in a contractual way that Solar Inc. is not to be liable for consequential damages. It is my view that to permit the plaintiff to recover consequential damages would result in a windfall and would distort a fundamental aspect of the bargain that was struck between these parties. I find, accordingly, that the defendant has satisfied the burden of demonstrating that there is no triable issue presented and that it is entitled to summary judgement dismissing the action.

Exclusion clauses must thus be read in conjunction with both the other terms of the contract as well as with the factual matrix surrounding the formation of the contract. Parties negotiating and drafting agreements must be aware that their conduct and positions taken prior to forming the contract as well as the inclusion of warranty provisions, damages caps, and contractual indemnity rights can all function to limit their exposure to claims for lost profits or other damages.

## **X. SO, WHAT IS A DEAL LAWYER TO DO?**

So how does a deal lawyer protect his or her client's interests in the purchase and sale of a business, particularly in light of the fact that there are no reported Canadian decisions in which a court has addressed the effect of a contractual consequential damages exclusion on a claim for lost profits or diminution in revenue in the context of a purchase or sale of a business? If nothing else is clear from the cases, the parties to a contract are best served by specifically addressing the kinds of risk each is willing to accept. The risk in assuming that lost revenue, overhead costs, or lost profits are consequential damages that will be captured by a boilerplate clause is significant for the seller if the other negotiated provisions, such as the warranty and damages cap, do not otherwise protect it from liability for these losses.

Sellers and their lawyers should not be content to rely on broad terms like direct damages or consequential damages to predict what losses a buyer can recover from the seller in the event of a contract breach. Again, as Justice David Brown of the Ontario Court of Appeal commented in *Atos IT*, reasonable people can (and do) disagree about the meaning of contractual provisions.<sup>132</sup> If a seller is unwilling to accept the risk that its breach of the bargain will leave it exposed to compensating the buyer for its lost profits, then the seller should specifically exclude lost profits entirely as a loss recoverable through damages and draft the exclusion in a way that entirely avoids the question of whether the plaintiff's lost profits are direct damages under the First Branch or consequential damages under the Second Branch. Where, however, it is clear that the primary expectation of one of the parties is to realize a profit from the contract, additional thought should be given to how to exclude or at least limit claims for lost profits, which may be seen as natural and direct results of any breach. This could be done, for example, through warranty or indemnity provisions that serve as the buyer's sole remedy for any seller breach. A complete contractual regime to compensate for losses caused by the parties' respective breaches may clarify the parties'

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<sup>132</sup> *Atos IT* (Ont. C.A.), *supra*, footnote 42, at para. 85.

intentions to limit their liability to the other. A damages cap could have a similar result, limiting the parties' overall exposure to any damages, however, characterized or caused.

Buyers and their lawyers, on the other hand, should obviously be wary of excluding consequential damages or lost profits. If the buyer needs to protect revenue streams resulting from the transaction (whether from the operation of the acquired business or from the use of the asset in its own operations), it should avoid excluding either lost profits specifically or consequential losses generally. Other risk mitigation devices, such as a meaningful warranty or an indemnity for the breach of representations and warranties can also help give the buyer comfort that it will get what it paid for. If the seller will not accept these risks, the buyer may be able to insure against the future loss of revenue in the event the business does not perform as bargained for.

Deal lawyers should not assume that the case law provides clear guidance enabling them to predict which losses will be considered consequential damages. Certainly, the modern approach to contractual interpretation no longer allows deal lawyers to rely on boilerplate or blanket exclusions of consequential damages. Whether the parties are concerned with repair and replacement costs, a shortfall in production, lost revenue and profits, a multiple of earnings, wasted overhead, or transportation and inspection costs, exclusion and limitation clauses should speak to the specific losses that the parties foresee. Deal lawyers and their clients should never be coy about what losses and what risks they are willing to assume, but should do their best to clearly define and limit what losses they expect to recover, and what losses they are unwilling to assume.