You Don't Know What You're Missing — How to Define and Exclude Consequential Damages

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Editor's Note

The concept of consequential damages is taught to first year law students as part of a basic introduction to contract law. The phrase "consequential damages" has been used in both standard form and custom contracts for many years and has been the subject of many court decisions. Despite the frequent use of this phrase, it continues to mean different things to different people, and conflicting case law on the meaning of the phrase is not always reconcilable. This paper contains a thorough analysis of the history, use and potential meanings of the phrase. The authors begin with a historical review, starting with the famous case of *Hadley v. Baxendale*, which introduced into contract law the exclusion of remote damages, but did so by creating two categories of remote damages. Commentators and contract drafters have attempted to clarify the meaning of the phrase by using synonyms such as "indirect damages", which has in some cases only confused the issue. The authors succinctly and clearly explain the concepts involved in this area of law, have provided suggestions for removing ambiguity, and discuss the interplay between consequential damages exclusion clauses and liquidated damages and indemnity clauses. Finally, the authors discuss two recent important cases on the subject of consequential damages, i.e., the Alberta Court of Appeal decision in *Dow Chemical Canada ULC v. NOVA Chemicals Corporation* and the Ontario Supreme Court decision in *Sunsource v. University of Windsor*.

1. INTRODUCTION

When parties enter into a business relationship, they must decide how to allocate the risk of losses incurred in the event of breach. When their mutual understanding of the deal is put to paper, this allocation is accomplished in part through exclusion of liability clauses. Such clauses come in different shapes and sizes depending on the commercial context and are common in construction contracts. Regardless of the form they take, exclusion of liability clauses all share a common objective: to shield

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the breaching party from certain types of damages that it would otherwise be liable under the common law. ''Consequential damages'' are one of the most common types of damages excluded from recovery by such clauses. The problem is, no one seems to know what it means — as one commentator put it, whenever ''you use in a contract a term of art such as 'consequential damages,' you're inviting confusion''.[2]

In many cases, the parties to a contract dispute will disagree about the scope and application of the exclusion of liability clauses in the governing agreements. As a result, before awarding damages for breach of contract, the court will have to determine whether those clauses apply to the circumstances of the breach.[3] When assessing a clause that excludes liability for consequential damages, the question breaks down into two parts: (1) what are ''consequential damages''? and (2) do the particular losses claimed meet that definition?[4]

This article examines the different definitions that have been applied to the term ''consequential damages'', considers the most recent case law on the subject, and proposes a solution for contract drafters attempting to wade through these murky waters. Part II begins with the roots of the common law rule for recovery of damages in breach of contract actions and traces its development to modern day jurisprudence. Part III examines how jurists and legal theorists have grappled with the introduction of ''consequential damages'' into the commercial lexicon in light of that common law tradition. It also explores the greater focus that the recent cases of *Dow Chemical* and *Sunsource v. University of Windsor*[5] place on the contract itself in understanding what the parties intended consequential losses to mean. Part IV concludes with recommendations on how commercial parties can clearly signal their intentions and take control of what it means to exclude ''consequential damages''.

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2 Ken Adams, ''New Article on Consequential Damages'' (23 July 2008), online: < www.adams-drafting.com/new-article-on-consequential-damages > .

3 *Tercon Contractors Ltd. v. British Columbia (Minister of Transportation & Highways)*, 2010 SCC 4 at paras. 121-123 [*Tercon*].

4 *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*, 2020 ABCA 320 at para. 51 [*Dow Chemical*].

5 *Sunsource v. University of Windsor*, 2022 ONSC 6047 (S.C.J.), additional reasons 2023 CarswellOnt 16362 (S.C.J.) [*Sunsource*].

2. COMMON LAW LIMITS ON RECOVERY

2.1 The Foreseeability Principle and *Hadley v. Baxendale*

One of the most important functions served by a contract is to replace common law rules with a new framework that better reflects the parties' intentions for their commercial partnership. In general, the courts give parties considerable leeway to "contract around" the common law.[6] Thus, in the context of breach of contract, the common law rules for recovery of damages apply unless the parties draft an exclusion clause that changes the allocation of risk for such losses.[7]

We begin this discussion on consequential damages, therefore, with two basic common law principles that govern recovery of damages for breach of contract.

The first, is the principle of reasonable expectation. It provides that "the claimant is entitled to be placed, so far as money can do it, in the same position as he [or she] would have been in had the contract been performed."[8] This principle, taken to its extreme, would completely compensate a claimant for "all loss *de facto* resulting from a particular breach, however improbable, however unpredictable."[9]

The courts, recognizing the harshness of such a rule, introduced the foreseeability principle to temper its application.[10] This second principle provides that the claimant's recovery shall be limited to losses that were "in the reasonable contemplation of the parties" at the time of contract formation, as expressed in the provisions of the contract itself.[11] A claimant's recovery is then further limited by the concept of "remoteness", which excludes from recovery those risks, while

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6 See e.g., *Marcovitz v. Bruker*, 2007 SCC 54 at para. 59 ("There are therefore only two limitations on the object of a contract: it cannot be prohibited by law or be contrary to public order"); *Tercon*, *supra* note 3 at para 85 (noting "the freedom of contract of sophisticated and experienced parties in a commercial environment to craft their own contractual relations"); *Dow Chemical*, *supra* note 4 at para 120, Binnie, J. dissenting on other grounds ("Parties are free to contract whenever and for whatever reason they wish. The only limits to absolute contractual freedom are certain restrictions imposed by legislation and by accepted ethics.").

7 *Dow Chemical*, *ibid* at para 56.

8 See James Edelman, ed, *McGregor on Damages*, 20th ed (London, UK: Sweet & Maxwell, 2018) at s 2-003; see also *NEP Canada ULC v. MEC OP LLC*, 2021 ABQB 180 at para. 1195 [*NEP Canada*] ("The principle of reasonable expectation is an indispensable component in contractual law."); see also *Fidler v. Sun Life Assurance Co. of Canada*, 2006 SCC 30 at paras. 27, 44 [*Fidler*].

9 *Victoria Laundry (Windsor) Ltd. v. Newman Industries Ltd.*, [1949] 1 All E.R. 997, [1949] 2 K.B. 528 (C.A.) at 1002 [All E.R.], [*Victoria Laundry*].

10 *Ibid* at 2002.

11 See Edelman, *supra* note 8 at s 8-166; *Fidler*, *supra* note 8 at para 44; Harvin D. Pitch and Ronald M. Snyder, *Damages for Breach of Contract*, 2nd ed (Toronto: Carswell, 2014) at s 7(1)-(2).

theoretically foreseeable, that the defendant would have considered unlikely to occur.[12]

The foreseeability principle derives from a case called *Hadley v. Baxendale*,[13] a tale of woe from the time of Charles Dickens.[14] Hadley and his business partner were millers and proprietors of the City Steam-Mills in the city of Gloucester, England. They powered their mill with a steam-engine, grinding corn into meal, flour, bran, and the like. The steam-engine in turn depended on the smooth functioning of a crankshaft. On May 11th, 1853, the crank shaft broke, bringing the mill to a "grinding" halt.[15]

Desperate to repair this piece of critical machinery, Hadley hired W. Joyce & Co., engineers based in Greenwich, to make a new crankshaft. To do so, the engineers needed Hadley to send them the old crankshaft, to serve as a model.[16]

Hadley selected a courier service called Pickford & Co to deliver the part. This courier service was run by Baxendale. When Hadley's servant came to arrange for the delivery, Baxendale's clerk promised that if the crankshaft was in their hands by noon of a given day, it would be delivered to Greenwich the next day. The crankshaft was delivered to Pickford & Co. the next day before 12pm, but it did not arrive in Greenwich the following day as promised. Nor the next. Nor the next. The crankshaft arrived at the engineers' office seven days later.[17]

Meanwhile, the mill stood silent. Hadley refined no corn into meal, flour, or bran. He could not fill many of his customers' orders and was forced to buy flour to fill others. He was losing profits by the hour and had to pay wages to idle workmen.[18] Seeking compensation for these losses, Hadley turned to the courts and sued Baxendale for 300 pounds.[19]

A jury awarded 50 pounds to Hadley for his losses. Subsequently, the matter came before Baron Edward Alderson at the Courts of Exchequer. The Baron ordered a new trial and set out the instructions which the trial judge was to give to the jury. These instructions laid down in law the foreseeability principle, divided into two branches.

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12 *"Heron II" (The) v. C. Czarnikow Ltd.*, [1967] 3 All E.R. 686 (U.K. H.L.) at 691 [*Heron II*].
13 (1854), 156 E.R. 145 (Exch.) [*Hadley*].
14 *Fidler, supra* note 8 at para 54.
15 *Hadley, supra* note 13 at 146.
16 *Ibid* at 146.
17 *Ibid.*
18 *Ibid* at 146.
19 *Ibid* at 147.

The first branch focuses on what would have been reasonably foreseeable to the parties at the time of contracting:

> 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 contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.[20]

Here, knowledge is imputed to the parties, regardless of what they actually knew.[21] These "objectively foreseeable damages"[22] are commonly referred to today as "direct" or "general" damages. They are recoverable without any special disclosures.

The second branch concerns the parties' actual knowledge at the time of contracting.[23] These "subjectively foreseeable damages"[24] are considered foreseeable (and therefore recoverable) only if the defendant actually knew of the risk:

> [I]f the special circumstances under which the contract was actually made where 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.
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> 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

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[20] *Hadley, supra* note 13 at 151 ("A plaintiff need establish only that the type or kind of injury was foreseeable, and not the foreseeability of the extent of the injury or the precise manner of its occurrence."); *NEP Canada*, *supra* note 8 at para 1198, citing *Phillip (Next Friend of) v. Bablitz*, 2011 ABCA 383 at para. 13, leave to appeal refused 2012 CarswellAlta 1181 (S.C.C.); *Millette v. Cote* (1974), (*sub nom.* R. v. Côté) [1976] 1 S.C.R. 595 at para. 604.

[21] *Victoria Laundry*, *supra* note 9 at 1002.

[22] John F. Clifford, Charlotte Conlin & Graham Bevans, "The Uncertain Consequences of Waiving Consequential Damages" (September 2020), at 2, online (pdf): <mcmillan.ca/wp-content/uploads/2020/09/The-Uncertain-Consequences-of-Waiving-Consequential-Damages.pdf> [*Clifford et al*]; G.L.H. Fridman, *The Law of Contract in Canada*, 6th ed (Toronto: Carswell, 2011) at 684 [*Fridman*].

[23] *Victoria Laundry*, *supra* note 9 at 2002.

[24] *Clifford et al*, *supra* note 22 at 2; *Fridman*, *supra* note 22 at 693.

> 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 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.[25]

That communication of special circumstances to the other party at the time of contracting brings the losses resulting from those special circumstances within the "reasonable contemplation" of the parties, it renders them foreseeable. If the plaintiff's losses do not fall into either branch of *Hadley*, they are not foreseeable at all and cannot be recovered.[26]

Applying the foreseeability principle to Hadley's plight, Baron Alderson held that the jury should not have taken his lost profits into consideration in estimating damages.[27] Baron Alderson found that the only communication made by Hadley to Baxendale was that the article to be delivered was the broken shaft of a mill operated by Hadley.[28] This communication did not reasonably inform Baxendale that an unreasonable delay in the delivery of the crankshaft would cause Hadley to lose profits. The special circumstances causing Hadley's losses — that the mill could not function until the crankshaft was delivered and replaced — were not made known to Baxendale. As Hadley's losses fell under the second branch, but the required disclosure of special circumstances was not made, they were not foreseeable, and he could not recover his lost profits.

2.2 The Evolution of *Hadley v. Baxendale*

2.2.1 Foreseeing Some Damages but Not All

Almost a century after Baron Alderson's ruling, the English Court of Appeal applied his reasoning to another dispute about lost profits, *Victoria Laundry (Windsor) Ltd. v. Newman Industries Ltd*, with different results.[29] The plaintiffs in this case were a laundry and dye business located near Windsor. After the Second World War, they

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[25] *Hadley, supra* note 13 at 151.
[26] *Clifford et al*, *supra* note 22 at 7-8.
[27] *Hadley, supra* note 13 at 152.
[28] The Baron's finding in this regard is a bit puzzling, as at trial, it was found that Hadley's servant informed Baxendale's clerk "that the mill was stopped, and that the shaft must be sent immediately" and that "a special entry, if required, should be made to hasten its delivery." (see *Hadley, supra* note 13 at 344).
[29] *Victoria Laundry*, *supra* note 9.

decided to expand their business. To support this growth, they purchased a bigger boiler from the defendants.[30]

Upon arriving to pick up the boiler, the plaintiffs discovered that it had been damaged by the contractors hired by the defendants to dismantle it. It took five months for the defendants to repair and finally deliver the boiler. The plaintiffs sued, claiming, among other things, the profits they would have earned by expanding their business had the boiler arrived on time, including "highly lucrative" contracts for a government ministry.[31] The lower court denied any recovery of lost profits and the plaintiffs appealed.

The Court of Appeal applied *Hadley* and assessed what the defendants knew at the time of contracting about the likelihood that the plaintiffs would lose profits if the boiler were delivered late.[32] Letters exchanged between the parties showed that the defendants knew that the plaintiffs needed the boiler for immediate use in their laundry and dye business, but did not know precisely what role the boiler was to play in the plaintiffs' business.[33]

The Court of Appeal determined that some of the plaintiffs' profits arose from the usual course of things.[34] A laundry and dye business in want of a boiler probably intends to use it to launder and dye things "for business advantage".[35] No supplier could reasonably contend that a loss of business would not likely result from a long delay in delivery of a boiler to such a business.[36] The foreseeability of this loss was increased in the specific context of the case, because there was a "famine of laundry facilities",[37] the plaintiffs agreed to pay a lot of money for the boiler, and they told the defendants they intended to put it to use immediately.[38]

But some of the plaintiffs' profits arose from special circumstances and were therefore subject to *Hadley's* second branch. The particularly lucrative government contracts that the plaintiffs expected were held unforeseeable unless the defendants actually knew, when they agreed to sell the boiler, "of the prospect and terms of such contracts."[39]

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30 *Ibid* at 998-99.
31 *Ibid* at 1000.
32 *Ibid* at 999.
33 *Ibid.*
34 *Ibid* at 1004-05.
35 *Ibid* at 1003.
36 *Ibid.*
37 The Court of Appeal seems to have assumed that the defendants knew about the "laundry facility famine."
38 *Victoria Laundry*, *supra* note 9 at 1004-05.
39 *Ibid* at 1005.

The trial court had made much of the fact that the defendants were only responsible for delivering a part of the plaintiffs' "profit-making machine" and therefore could not have known the impact of a delayed delivery. The Court of Appeal corrected this analysis. That the boiler made up only a part of the plaintiffs' business was a factor to consider in determining whether lost profits would reasonably have been foreseen, but it was not determinative.[40] In *Hadley*, Baxendale had no obligation to compensate Hadley for lost profits, not because the crankshaft was just a part of a whole, but because nothing about the situation informed him that "want of that part would stultify the whole business".[41] Unlike Baxendale, the defendants in *Victoria Laundry* should have known that the plaintiffs would suffer some degree of business loss without the boiler.[42] The Court of Appeal referred the case to an official referee to assess just how much the plaintiffs were entitled to recover for lost profits.[43]

Foreseeability is *Hadley*'s bedrock. As noted by the House of Lords in the *Heron II*[44], the two branches in *Hadley* are not truly separate rules but a continuum: the first branch are losses that are objectively foreseeable, and the second, those that were foreseeable to the parties in the circumstances.

The discussion of reasonable foreseeability, however, does not stand alone. Rather, a second component of reasonable foreseeability — remoteness — is often absent from the discussion about what otherwise recoverable losses might be excluded by a contract. Remoteness, however, does not offer us much help in deciding when lost profits (or other losses) are recoverable. Rather, it places a condition on foreseeability, limiting recovery for only those foreseeable risks that are "real risks" or risks that a reasonable businessperson would not consider to be "far fetched".[45]

In the view of the Supreme Court of Canada, remoteness, is a limiting principle that:

> aims "to prevent unfair surprise to the defendant, to ensure a fair allocation of risks of the transaction, and to avoid any overly chilling effects on useful activities by the threat of unlimited liability"; (Jamie Cassels and Elizabeth Adjin-Tetty, *Remedies: The Law of Damages* (2nd ed. 2008) at p. 352). This

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40 *Ibid.*
41 *Ibid.*
42 *Ibid.*
43 *Ibid.*
44 *Heron II*, *supra* note 11.
45 *Mustapha v. Culligan of Canada Ltd.*, 2008 SCC 27 at para. 13.

> principle will be informed by the nature and culture of the business in question, and the particular contractual relationship between the parties . . .". [46]

Therefore, recoverable losses must also be ones that are not "too remote" or unfair to assign to the breaching party.

2.2.2 Non-Pecuniary Losses and the Objective Person Standard

The next major development in *Hadley's* evolution came with *Fidler v. Sun Life Assurance Co. of Canada*, in which the Supreme Court upheld an award of damages for non-pecuniary losses resulting from a breach of contract (in this case, mental distress for a wrongful denial of long-term disability benefits).[47]

Connie Fidler worked as a receptionist for the Royal Bank of Canada.[48] As an employee, she had benefits, including long-term disability, through a Sun Life Company of Canada ("**Sun Life**") group policy (the "**Policy**").[49] In 1990, at the age of 36, she was diagnosed with chronic fatigue syndrome and fibromyalgia, and submitted a long-term disability claim under the Policy.[50] After some initial reluctance, Sun Life began paying long-term disability to Fidler in January 1991.[51] Six years later, Sun Life terminated her benefits, because video surveillance obtained through a "non-medical investigation" showed Fidler engaging in activities like driving and shopping, leading Sun Life to conclude that she could work.[52] Fidler sued for, among other things, damages for distress and discomfort she suffered due to the loss of disability coverage.[53]

The trial court awarded $20,000 for mental distress, which was upheld by the Court of Appeal and the Supreme Court.[54] The Supreme Court had this to say about *Hadley*:

> We conclude that damages for mental distress for breach of contract may, in appropriate cases, be awarded as an application of the principle in *Hadley v. Baxendale*. The court

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46 *RBC Dominion Securities Inc. v. Merrill Lynch Canada Inc.*, 2008 SCC 54 at para. 64, Abella J., dissenting in part.
47 *Fidler, supra* note 8 at para 56.
48 *Ibid* at para 3.
49 *Ibid.*
50 *Ibid* at para 4.
51 *Ibid* at paras 5, 7.
52 *Ibid* at paras 9-10.
53 After Sun Life terminated Ms. Fidler's long-term benefits, there were nearly two years of correspondence between Ms. Fidler and various medical professionals, investigators and claim examiners to assess her condition.
54 *Fidler, supra* note 8 at para 54.

> should ask "what did the contract promise?" and provide compensation for those promises. ... The law's task is simply to provide the benefits contracted for, whatever their nature, if they were in the reasonable contemplation of the parties.
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> . . .
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> It follows that there is only one rule by which compensatory damages for breach of contract should be assessed: the rule in *Hadley v. Baxendale*. The *Hadley* test unites all forms of contractual damages under a single principle. It explains why damages may be awarded where an object of the contract is to secure a psychological benefit, just as they may be awarded where an object of the contract is to secure a material one. . .. In all cases, these results are based on what was in the reasonable contemplation of the parties at the time of contract formation.[55]

Consistent with the notion of a single continuum as noted in *Heron II*, this passage does not invoke either the first or second branch of *Hadley*. Instead, the Court focuses on a different phrase from *Hadley*, "reasonable contemplation". In essence, the foreseeability principle is ultimately a test for finding out what was in parties' "reasonable contemplation", but if there are special circumstances afoot, then special disclosures may be necessary to bring certain damages within the parties' reasonable contemplation. The Alberta Court of Appeal explained it thus:

> The recoverable damages are those that would be in the reasonable contemplation of the parties at the time of contract. There is only one rule, but if "special circumstances" have been communicated, then the damages within the parties' reasonable contemplation would be wider.[56]

The Court held that the parties had reasonably contemplated Fidler's mental distress, because one object of the disability insurance contract was "to secure a psychological benefit" by making an insured feel secure in the knowledge that if he or she suffered a disability, there would be a financial safety net.[57]

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[55] *Ibid* at paras 44, 54 (internal citations omitted).

[56] *Dow Chemical, supra* note 4 at para 57. This is in contrast with how some other courts have dealt with this phrase. See, e.g., *Sunsource*, *supra* note 5 at para 874 ("There are two branches to the *Hadley v. Baxendale* remoteness test. Damages may be recovered if: (i) in the "usual course of things", they arise fairly, reasonably, and naturally as a result of the breach of contract; or (ii) they were within the reasonable contemplation of the parties at the time of contract".).

[57] *Fidler*, *supra* note 8 at para 56.

3. A SQUARE PEG IN A ROUND HOLE: CONSEQUENTIAL DAMAGES AND THE COMMON LAW

Hadley and its progeny did not use the term "consequential damages" — that language entered the legal lexicon later, by way of commercial contracts and specifically, the exclusion clause.[58] Once disputes began to arise about the interpretation of exclusion clauses purporting to exclude liability for "consequential damages", the courts were faced with the necessity of reconciling this new term with the common law rules set down in *Hadley*.

Putting aside the notion of a single continuum as developed in later cases for the moment, it can be said that *Hadley* and its progeny classify damages into three categories: (1) losses that are recoverable because they arise naturally, in the "usual course of things", such that the parties are presumed to have contemplated them; (2) losses that are recoverable because they arise from special circumstances that were known to both parties at the time of contracting; and (3) losses that are either unforeseeable or too remote.

Parties use exclusion clauses to allocate risk by limiting the damages recoverable to an amount less than what the common law would otherwise allow.[59] So "consequential damages" must constitute a subset of those damages that *Hadley* would deem recoverable.[60] Consequential damages cannot be equated with damages that are inherently unforeseeable or too remote because then the exclusion clause would serve no purpose.

Consequential damages, then, seems to mean something other than losses falling in the first branch of *Hadley* (objectively foreseeable or "**Ordinary Course Losses**"), and should be understood either as losses falling in the second branch of *Hadley* (foreseeable in the special circumstances or "**Special Circumstance Losses**") or as something slightly different, being losses which are related to either the Ordinary Course Losses or Special Circumstance Losses, and which, because these losses are not speculative, are fairly borne by the party on the breach.

Whatever "consequential damages" are, it is axiomatic that they must be compensation for reasonably foreseeable losses (or, as sometimes said, not too remote). The mismatch between the *Hadley* framework and what contract drafters think of as being consequential losses could be framed as a separate question: what is the relationship of the losses said to be

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[58] *Dow Chemical, supra* note 4 at para 58.
[59] *Ibid* at para 56.
[60] *Ibid* at para 77.

excluded as consequential losses *to the direct losses*? This question is not necessarily the same as asking which losses are foreseeable as those arising naturally from the breach and which other losses are foreseeable in the special circumstances communicated between the parties.

The next section looks at the different methods adopted by courts and commentators to define "consequential damages".

3.1 Consequential Damages as Beyond Market Value Losses

Among many businesspeople and their lawyers, "consequential damages" means anything beyond the "normal" measure of damages and are inherently losses "that are economic in nature".[61] This is often assumed to mean that lost profits (or other types of losses, such as loss of goodwill) are consequential damages, even though courts have long recognized that lost profits are often the normal measure of damages where the contract involves a profit-making chattel.

This perspective appears similar to that advanced by McGregor on Damages, the leading UK reference text on damages, as the "useful and important division between normal and consequential losses":

> The normal loss is that loss which every claimant in a like situation will suffer; the consequential loss is that loss which is special to the circumstances of the particular claimant.[62]

This sounds very much like the distinction set down in *Hadley*. But McGregor continues:

> 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 losses particular to the claimant include anything beyond this normal measure and are recoverable if not too remote.[63]

As McGregor emphasizes, the distinction is not the same as that between the first and the second branches in *Hadley v. Baxendale*: a consequential loss may well be within the first branch.[64]

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[61] Jane E Sidnell, "Consequential Damages: Are Exclusions of Consequential Damages Inconsequential?" (2010) J. Can. C. Construction Law 109 at 109 ["Sidnell"].
[62] See Edelman, *supra* note 8 at s 3-008.
[63] *Ibid.*
[64] *Ibid* at s 3-015.

McGregor accordingly steps away from foreseeability as a framework and, instead, adopts a definition based on commercial experience, where market value is generally the normal measure for compensation and additional losses are consequential damages. As will be seen below in discussing *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*, what constitutes "normal" compensation is not always easy to determine and must be evaluated on a case-by-case basis, depending on the nature of the contract and the parties' intentions.

Some commentators have urged the courts to adopt this "normal vs. everything else" approach to bring the definition of consequential damages into line with the reality of business negotiations.[65] But, as McGregor admits, "in the context of contractual exclusions of liability for consequential loss or damage, the courts have consistently seen the distinction between normal loss and consequential loss differently, as that between losses falling within the first and second rules [i.e., branches] in *Hadley v Baxendale*."[66] While attractive in its simplicity and common sense, the courts have proven reluctant to embrace McGregor's perspective, in part because it is often difficult to identify what those "normal" losses are.[67]

3.1 Consequential Damages as Special Circumstance Losses

Many courts prefer to fit "consequential damages" into *Hadley's* framework by defining the term using a "test based purely on foreseeability".[68] Courts adopting this approach equate "consequential damages" with losses arising from special circumstances, the second branch of *Hadley*. This has generally been considered the prevailing judicial view in the UK[69] and Canada.[70]

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65 Sidnell, *supra* note 61 at 129.

66 See Edelman, *supra* note 8 at s 3-013.

67 *Ibid* at s 1-037. See also Sidnell, *supra* note 61 at para 109. See also *Environmental Systems Pty Ltd. v. Peerless Holdings Pty Ltd.* (2008), 19 VR 358 (CA Austl.) at para. 87, holding that it was incorrect to equate consequential damages with the second branch of *Hadley*. Note that wasn't the last word in Australia, though: See Will Coulthard and Rebecca Cifelli, "Consequential Loss: do you know what you are excluding?" (Sep. 2017), online: <jws.com.au/insights/articles/2017-articles/consequential-loss-do-you-know-what-you-are-exclud>; Sarah Jeremie Witt Grenfell and Marc Rathbone, "Law and Regulation of Consequential Damages Clauses in the Energy Sector in Australia" (May 27, 2020), online: .

68 Christa Brothers and Tipper McEwan, "Consequential Damages for Breach of Contract: A Primer on the Principles" (2011) Archibald Ann Rev Civ Lit at para 3 and note 13, citing Shannon Salter, "Clauses limiting liability must specify type of loss parties wish to exclude" (2007) 27:22 The Lawyers Weekly.

69 See Edelman, *supra* note 8 at s 3-013; *Dow Chemical*, *supra* note 4 at para 58, citing J. Edelman, *McGregor on Damages*, 20th ed, (London: Sweet & Maxwell Ltd., 2018) at paras 3-12 to 3-16.

70 See, e.g., E Sidnell, *supra* note 61 at 121; *Clifford et al*, *supra* note 22 at 10, (suggesting that in the absence of clarity, "consequential damages are best understood as losses falling under the Second Branch").

There is, however, a practical problem with this view as pointed out by McGregor:

> It is also illogical and fails to make practical sense to confine consequential loss in contract to loss falling within the second rule in *Hadley v Baxendale*, being contradictory for one contracting party to communicate special circumstances to the other so as to fix him with a liability for loss to which he would not otherwise be subject and at the same time to accept an exclusion of liability in respect of the selfsame loss.[71]

It may be satisfyingly clean, from an analytical point of view, to equate consequential damages with *Hadley's* second branch. Indeed, one of the authors of this article had, prior to the Alberta Court of Appeal's decision in *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*, concluded that the safest course for lawyers, in advising their clients, is to assume a court will conclude that this is what the parties meant when they excluded consequential losses. However, in reality, when parties turn their minds to what risks they are prepared to accept, and those which they will not, it is unlikely that they identify those losses in line with the framework in *Hadley* or understand that the word "consequential" means the foreseeable losses arising in their special circumstances. Instead, the confusion often arises not between "normal" and "consequential" but their sometimes-used synonyms "direct" and "indirect" and the draftsperson's use of the term "consequential" (or indirect) to place a ringfence around losses for which they accept responsibility, and those that they do not. How else then might the term be defined?

3.2 Consequential Damages as Causally Related Downstream Losses

Some commentators adopt the view that interprets direct damages and consequential damages not in terms of *foreseeability*, as did *Hadley*, but in terms of their causal relationship to other losses. For example, Angela Swan, in *Canadian Contract Law*, defines "consequential" damages as those that "are in addition to or that arise as a consequence of the direct damages of the promisor's breach."[72]

> In this understanding, damages under the first branch are the *immediate or direct* results of the breach. They are sometimes referred to as the *natural or even physical consequences* of the

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[71] See Edelman, *supra* note 8 at s 3-014.

[72] Angela Swan, *Canadian Contract Law*, 1st ed (Toronto: LexisNexis, 2006) at 296-97 [emphasis added]. See also Christa Brothers and Tipper McEwan, *supra* note 68, at para 3 ("Consequential damages are losses that are at least once removed from the breach of the contract.")

> breach. Damages under the second branch are the less direct or subsequent consequences of the breach itself or even of those immediate consequences that fall under the first branch.[73] [emphasis added.]

Like the business view, this approach rejects the two branches in *Hadley* as the framework for *defining* "consequential damages". Instead, consequential damages are understood as losses that arise *as a result of* the direct damages or that are otherwise causally distanced from the original breach.[74] Commentators have characterized this causation framework as the minority approach in the courts.[75]

Other sources conflate or combine causation and foreseeability when defining "consequential damages". For example, earlier versions of Black's Law Dictionary state:

> *Consequential damages*. 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. [i.e., a causal relationship between losses and the breach] Damages which arise from intervention of special circumstances not ordinarily predictable. [i.e., foreseeability] Those losses or injuries which are a result of an act but are not ordinarily predictable. [i.e., not ordinarily foreseeable or remote] Those losses or injuries which are a result of an act but are not direct and immediate. [i.e., their causal relationship to the breach][76]

The most recent edition of Black's has revised this definition, keeping only the first sentence: "Losses that do not flow directly and immediately from an injurious act but that result indirectly from the act. — Also termed *indirect damages*".[77]

Any clarity gained by the foregoing revision is, however, compromised by the decision to also include the following quotation:[78]

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73 *Clifford et al*, supra note 22 at 13.
74 *Ibid* at 8.
75 See, e.g., *ibid* at 13; *Agfaphoto Canada Inc. v. Overwaitea Food Group Ltd.*, 2008 BCSC 1287 where the trial judge rejected a strained interpretation that the exclusion of "lost profits, indirect, special, punitive or consequential damages" did not include lost profits arising directly from the breach because (at para 25) such a distinction was a "depart[ure] from the established Canadian law of contract damages", as reflected in *McGregor on Damages*, *supra* note 8.
76 Joseph R. Nolan and Jacqueline M. Nolan-Haley et al, *Black's Law Dictionary*, 6th ed (St. Paul: West Publishing Co., 1990) sub verbo "consequential damages".
77 Bryan Garner, ed, *Black's Law Dictionary*, 11th ed (St. Paul: Thomson Reuters, 2019) sub verbo "consequential damages".
78 *Ibid.*

> "No discussion of consequential damages can be profitable unless we first define what we mean by this elusive concept. Admittedly, the concept is ambiguous and equivocal. Nevertheless, it is a usual and useful rubric to denote varied types of losses, for some of which the courts consistently allow recovery, for others of which there is never recovery, and for still others of which the courts allow or deny recovery depending upon the degree of remoteness, the pertinent constitution and the philosophy of the judges deciding the issue . . . Consequential damages typically embrace such indirect and uncompensated losses as good will, business profits, removal expenses, and losses resulting from obstruction to light, air, view and access." Emerson G. Spies & John C. McCoid II, *Recovery of Consequential Damages in Eminent Domain*, 48 Va. L. Rev. 437, 440—41 (1962).[79]

Not surprisingly, courts at times conflate the concepts of foreseeability and causation as they struggle to explain why some claims for lost profits are direct losses and some claims are irrecoverable consequential or indirect losses. Businesspeople are therefore left with a lack of clarity as to how they should describe the risks that they are not willing to accept in the event that the other party to their bargain fails to do what it promised.

For the sake of maintaining clear distinctions relating to legal liability, we should keep causation separate from foreseeability and be clear about what we mean when using the word "causation". Causation is a prerequisite for liability for breach of contract — the breach must have caused the plaintiff's losses. Causation, as a threshold inquiry for liability, looks to the link between the failure to perform (the breach) and the losses the innocent party suffered. Causation in this sense comes into play once the proceedings have reached the point at which the plaintiff must *prove* which alleged damages actually occurred as a result of the breach:[80]

> A finding that a type of loss is objectively foreseeable does not equate to a finding that the loss occurred, in fact, as a result of the breach. The plaintiff must still prove the fact of the loss and its causal connection to the breach.[81]

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79 *Ibid.*

80 See Christa Brothers and Tipper McEwan, *supra* note 68 at para 10 ("The principles of reasonable contemplation do 'not obviate the requirement that a plaintiff prove his or her loss'").

81 *Sunsource*, *supra* note 5 at para 896.

Foreseeability cannot support the weight placed on it in the determination of which losses are consequential losses. The description of losses that are Ordinary Course Losses (i.e., the first branch of *Hadley*) and those that are Special Circumstance Losses (i.e., the second branch of *Hadley*) are both, by definition, foreseeable. Special Circumstance Losses, however, are losses that otherwise would be too remote, absent communication of those special circumstances. When we look to the risks the parties agree to assume in their bargain, the party agreeing to perform a service or deliver goods may well refuse to accept that now foreseeable risk. This may include the risk of the other party's lost profits that result from the failure to adequately perform a service or provide the goods in a proper and timely manner. Consequential losses, however, must be something more than just Special Circumstances Losses.

There must be a way to avoid conflating or confusing causation and foreseeability when defining consequential losses. In determining which losses are direct losses (those naturally flowing from the breach), and those which businesspeople think of as consequential losses, the answer perhaps lies in the way in which a plaintiff's recoverable losses are related *to each other*. We think that this is the sense in which McGregor uses the word "consequential", not to mean Special Circumstance Losses, but losses that are the secondary result of the immediate losses caused by the defendant's failure to perform. This requires us to consider how far along a chain of causally sequential and related losses (losses incurred as a consequence of the immediate result of the breach) we go in determining what losses are recoverable. A useful way to think of consequential losses is to understand them as knock-on or downstream losses.

Imagine a tomato grower in Leamington that just secured an order to supply tomatoes to a grocery chain. It's a lucrative contract with considerable risk. To meet these new orders, the grower will have to build three new greenhouses and so, orders a heating system that is capable of heating the three greenhouses, for delivery on a specific date. If the manufacturer cannot deliver the heating system, or if the heating system it delivers does not heat as efficiently as promised, then *Hadley* tells us that the manufacturer will be liable in damages for the grower's losses so long as they are foreseeable and not too remote, namely, the cost of modifying the system so that it can meet the grower's stated needs or in replacing the manufacturer's system with one that can.

What is foreseeable to the manufacturer, however, changes with what the manufacturer knows. If the grower tells the manufacturer that he

needs to expand his operation to fill a new supply contract with the grocery chain, and that in order to plant his crops in time, that he needs the new heating system delivered to him by the specified date, and the manufacturer does not deliver the heating system on time, or the heating system does not heat as efficiently as promised, *Victoria Laundry* teaches us that the manufacturer can expect to be liable in damages for the purchaser's expenses in replacing or modifying the heating system or modifying them, as well as its lost profits from the tomato orders it could not fill. The primary loss is the failure to deliver the heating system; a recoverable secondary loss or the revenue producing crop because the grower cannot fill the tomato orders.

Does more information increase the manufacturer's risk? What if, for example, the grower told the manufacturer that the grocery chain is very demanding and that if it doesn't deliver the tomatoes promised on time and in the amounts agreed, it will have to pay late fees and liquidated damages to the grocer? Worse, what if the greenhouse operator also points out that he has taken on a significant bank loan, secured by his house, to cover its increased capital and operating expenses for the new greenhouses and its first growing season, which it can only pay off if it meets its sales targets? These potential losses, which ordinarily would not be foreseeable or if foreseeable, likely too remote (that is, the manufacturer would ordinarily think of these types of losses as being unlikely to occur) have been communicated to the manufacturer as special circumstances. These losses, however, are also the very kinds of risks that the manufacturer would expect its lawyer to protect if from in the contract by excluding its liability for consequential and indirect losses.

The problem is not that these losses are Special Circumstance Losses. The problem is the relationship of these losses to the breach and primary (or first) loss - the failure to deliver the heating system. The grower's lost profits and liability to pay liquidated damages to the grocer are losses that arise from the breach and primary loss (the failure to deliver the heating system). The default on the bank loan follows on from the lost profits and liquidated damages the grower has to pay the grocer for its failure to deliver the tomatoes, because it no longer has the funds to meet its payment obligations. The grower's default on the bank loan and the loss of his home due to foreclosure are tertiary to the breach and primary loss. We have little difficulty seeing why a court would not allow recovery for the secondary and tertiary losses. A court would call these losses too remote and move on.

However, if we want to really understand why some losses are consequential, and others are not, this example shows why we cannot just say that its because these losses are Special Circumstance Losses under *Hadley*. We accept that liability for the manufacturer's losses must end somewhere whether or not these losses are foreseeable in the special circumstances. No contractor, manufacturer or supplier would readily accept liability for these kinds of downstream losses; not because the losses are not foreseeable, but because the contractor, manufacturer or supplier are not insurers and the increasingly distant causal relationship between these losses makes it unreasonable to assign these losses to the party in default.

3.3 So, What About Lost Profits?

The most common reason a consequential loss exclusion is included in a contract is because one or both parties do not want to assume the risk of the business losses the other side may incur if the contract cannot be performed. As was the case in *Hadley,* the risk of compensating the other party for their lost profits may clearly outweigh the value of the contract. And, how courts have treated claims for lost profits as a measure of damages since *Hadley* demonstrates how terribly risky it is for parties to assume that lost profits are synonymous with consequential damages. If there is only one point to be made in this article, it is that lost profits are not always consequential losses. Depending on the nature of the contract, lost profits can be, and often are, losses that flow naturally and directly from the breach. It all depends on the contract.[82] Certainly, any generalization that lost profits are usually direct losses or are always consequential losses is not at all supported by the case law. Generalizations (which are often memorialized in boilerplate) have only added to the confusion about how the parties have allocated business risks, such as lost revenue or lost profits, above and beyond the price struck for their bargain.

The two recent cases below demonstrate the danger of not addressing head-on the allocation of risk for lost profits and instead, leaving it to the courts to determine whether lost profits are consequential losses.

3.3.1 Dow Chemical Canada ULC v. NOVA Chemicals Corporation

In *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*[83], the defendant, Nova, owned and operated a large petrochemical complex in

[82] See e.g., *ibid* at paras 1229-33; *Dow Chemical*, *supra* note 4 at para 52 et seq; see Edelman, *supra* note 8 at s 3-008; see *Sidnell*, *supra* note 61 at 114.

[83] *Dow Chemical*, *supra* note 4.

Alberta. The complex housed numerous plants, including three ethane crackers and two polyethylene plants.[84] Ethane is a hydrocarbon gas whose main use is ethylene production, a process carried out by ethane crackers.[85] Once produced, ethylene is then fed to a polyethylene plant, where it is transformed into polyethylene products, the building blocks of plastic.[86]

The first two ethane crackers, "E1" and "E2", were owned and operated by Nova alone. Its customers delivered the ethane and Nova "cracked" the ethane to create ethylene, which it then returned to the customer.[87] Nova operated the plants on a unitized basis, averaging the cost of converting ethane into ethylene.[88]

The dispute between the plaintiffs, Dow Chemical Canada ULC and Dow Europe GmbH (collectively, "**Dow**"), and Nova arose from the operation of the third ethane cracker, "E3".[89] E3 was initially constructed as a joint venture between Nova and Union Carbide. Union Carbide needed an ethylene supply for a polyethylene plant it planned to build nearby.[90] E3 was the solution. Nova and Union Carbide entered into an Operating and Services agreement under which Nova agreed to supply ethane for E3 and to operate the plant, generating ethylene, a portion of which Union Carbide was entitled to receive. In return, Union Carbide would not buy ethane in competition with Nova.[91]

Around the year 2000, two events occurred that set the stage for the drama that followed. First, a corporate merger took place and Dow stepped into Union Carbide's shoes.[92] While Union Carbide did not produce its own ethane and posed no threat to Nova in that market, Dow was Nova's direct competitor.[93] Second, around the time of the merger, Alberta began to experience an ethane shortage. Nova had enough ethane to supply E3, but not enough to feed all three of its ethane crackers to their designed capacity (their "**nameplate capacity**").[94]

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84 *Ibid* at para 2.
85 U.S. Energy Information Administration, "Hydrocarbon gas liquids explained" (last modified 11, October 2023), online (website): <eia.gov/energyexplained/hydrocarbon-gas-liquids/uses-of-hydrocarbon-gas-liquids.php>.
86 *Dow Chemical*, *supra* note 4 at para 53.
87 Strangely, the Court later states that Nova was not in the "merchant ethylene business" and did not sell ethylene "into the market, as an end unto itself," although it describes Nova as having customers for ethylene, including Union Carbide and Dow. See para 53.
88 *Ibid* at para 3.
89 *Ibid.*
90 *Ibid.*
91 *Ibid.*
92 *Ibid* at para 4.
93 *Ibid.*
94 *Ibid* at para 8.

In 2001, Nova introduced a new ethane supply management strategy at its petrochemical complex, called "ethane allocation". Nova notionally allocated ethane to the three ethane crackers based on their nameplate capacity.[95] In reality, it allocated more ethane to E3, which was the cheapest plant to operate, while dividing the ethylene produced by E3 with Dow as though some of that ethylene had actually been produced by E1 or E2.

As the ethane shortage began to make itself felt, Dow took issue with Nova's new supply management approach. Nova asserted that it had the right to allocate its ethane supply among its various plants, to "share the pain" of the shortage.[96] Dow argued that Nova had a contractual obligation to run E3 at full capacity, which would leave less ethane for E1 and E2 and shift the risk of any ethane shortfall to Nova alone. By 2004, Nova had more ethylene than it needed, and scaled production to match reduced demand, leaving Dow short of the ethylene it required.[97] Litigation followed.

The trial judge found Nova in breach of the underlying agreement, which required Nova to operate E3 at full capacity and entitled Dow to 50% of all ethylene produced by E3, not just 50% of the amount notionally allocated to E3.[98] The trial was complex and involved numerous issues. What is of specific relevance to this article is the trial judge's interpretation of the exclusion of liability clause and the allocation of risk between the parties of various losses.

The Operating and Services Agreement provided the following definitions:

> 1.1 In this Agreement and the recitals and schedules hereto:
>
> (u) "**Damages**" means costs, expenses (including without limitation legal fees incurred by a party on a solicitor and his own client basis), damages (including without limitation damages resulting from injury, death or property damage), losses, liabilities and obligations, including those arising from or in connection with any demand, claim, proceeding, action, judgment, lien, fine, penalty or tax (other than income tax). Damages shall include, without limitation, indirect or consequential damages (including without limitation loss of profits and damages arising from loss of production),

[95] *Ibid* at para 9.
[96] *Ibid* at para 10.
[97] *Ibid* at para 11.
[98] *Ibid* at para 14.

incidental damages, exemplary damages, punitive damages and similar damages.

(ai) "**Excluded Damages**" means (i) exclusive of Damages arising from claims by third parties, **indirect or consequential damages (including without limitation loss of profits and damages arising from loss of production)**, incidental damages, exemplary damages, punitive damages and similar damages; and (ii) loss of or damage to the Plant or the Products.

[emphasis added]

The Operating and Services Agreement then limited Nova's liability for Excluded Damages:

14.1 Liability of Operator

Without limiting any other provisions of this Agreement, including without limitation Section 14.4, the Operator and its Beneficiaries shall have no liability for Damages incurred or suffered by the Co-owners or either of them, no matter how such Damages or the right or claim to such Damages is created or may arise, including without limitation, Damages:

(a) for breach of contract, including without limitation breach of the Operator's obligations pursuant to this Agreement, which includes fundamental breach and also includes any breach depriving either of the Co-owners of all or substantially all of the benefit for which it contracted;

(b) for torts of any nature or degree whatsoever, committed by the Operator or by any of its Beneficiaries or any Person for whom the Operator may be responsible for any reason whatever relating in any way whatsoever to the Operator's involvement as operator in the Plant or the Infrastructure and notwithstanding any associated breach of any Regulation;

(c) as a consequence of a fiduciary relationship arising between or being imposed upon the Operator and the Co-owners as a result of this Agreement notwithstanding the express intention and agreement of the Parties that no such fiduciary relationship be created or exist; or

(d) whether arising at common law or in equity, or by Regulation, or in any other way for any reason whatsoever as a result of the Operator's performance as operator of the Plant or the Infrastructure,

> **except** when and to the extent that such Damages result or arise from the Gross Negligence or Wilful Misconduct of the Operator in which case the Operator shall be liable to and shall indemnify each of the Co-owners to the extent of its Damages. **Notwithstanding the foregoing, in no event shall the Operator be liable for (i) Excluded Damages**, (ii) Damages arising from any claim by an Associated Third Party of either Co-owner from which it is indemnified as provide in Section 14.2, and (iii) Damages from which the Operator is released as provided for in Section 14.4.
>
> [emphasis added]

The question for the trial judge was whether the Operating and Services Agreement excluded Dow's claim for lost profits from the polyethylene it was unable to produce as a result of the shorted ethylene deliveries. The trial judge reviewed the Canadian and English authorities extensively before concluding that "[i]n this case, it must surely have been foreseen by the parties that a failure to provide ethylene would result in a Co-owner suffering loss of profit" and in the circumstances, Dow's "the loss of profit and loss of production damages" for its allocation claim and optimization claims arose naturally from Nova's breach of contract.[99] These lost profits were characterized as direct damages flowing from Nova's breach. Thus, these lost profits were not consequential losses and were not unrecoverable Excluded Damages. The trial judge explained that Excluded Damages applied only "in the context of indirect or consequential damages and do not clearly and unambiguously preclude liability for any kind of lost profit. The trial judge awarded $1.4 billion in damages to Dow, including lost profits from its lost sales of polyethylene.[100]

On appeal, Nova advanced a slightly different argument. Nova conceded that the definition of Excluded Damages meant that it could be on the hook for "direct" loss of profits or production and that Dow was entitled to recover the lost value of the shorted ethylene.[101] But, it argued, any profits that Dow could have made from selling polyethylene were downstream losses and as a result, constituted "indirect or consequential" losses that were unrecoverable Excluded Damages.[102] This question split the Court of Appeal.

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[99] *Dow Chemical Canada ULC v. NOVA Chemicals Corporation*, 2018 ABQB 482 at para. 1035 [*Dow Chemical* ABQB], reversed in part 2020 CarswellAlta 1643 (C.A.).

[100] *Ibid* at para 1.

[101] *Dow Chemical*, *supra* note 4 at para 61.

[102] *Ibid* at paras 54, 61. Due to Nova's new stance on appeal, the trial court had not had the opportunity to directly address this question. *Ibid* at para 72.

The majority of the Court of Appeal allowed Nova's appeal. It noted that many English courts, in an attempt to fit the terms "direct" and "consequential" into the structure of the *Hadley* test, equated "consequential damages" with the second branch of *Hadley*. The majority of the Court of Appeal rejected this approach, because "[t]he starting point, as in every case of construction of contracts, is the terms of the contract itself."[103]

The majority of the Court of Appeal held that Dow's damages under the contract were "*prima facie* the value of the ethylene it was entitled to under the contract, but did not get", minus the cost of producing it.[104] These damages, the Court concluded, were "direct" and not excluded from recovery:

> In a contract like this, for the delivery of a product, the loss of the value of the product is the direct damage. Anything above the market value of the undelivered product is *prima facie* "indirect or consequential".[105]

This conclusion reminds us of McGregor's teaching that "normal" damages are generally the market value of the services that should have been received under the contract, and that "consequential losses" are anything beyond this. Indeed, the Court of Appeal approved of McGregor's rejection of any approach that equates "consequential damages" with the second branch of *Hadley*.[106]

To determine whether downstream losses from unrealized polyethylene sales were direct or consequential, the majority of the Court of Appeal turned to the language of the contract, in light of its purpose and commercial context.[107] This broader context included Nova's understanding that Dow's only use for the ethylene was to produce polyethylene. Despite this, the majority of the Court of Appeal noted that the Operating and Services Agreement itself focused on ethylene, and did not mention polyethylene production, "justifying the inference that its production was 'indirect and consequential'."[108] Furthermore, the fee Nova received for operating E3 "was modest compared to the amounts of money involved, the risks Nova assumed, and the scale of the operation of E3."[109] In light of this, the majority of the Court of Appeal concluded that it would be unreasonable to conclude that Nova

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[103] *Ibid* at para 58.
[104] *Ibid* at para 80.
[105] *Ibid* at para 80 (internal citation omitted).
[106] *Ibid* at para 58.
[107] *Ibid* at para 82.
[108] *Ibid* at para 81.
[109] *Ibid* at para 82.

accepted the risk of liability for Dow's downstream profit losses from the sale of polyethylene if Nova failed to deliver the contracted volume of ethylene.

Considering all these factors, the Court of Appeal held that Dow's lost profits from polyethylene sales constituted indirect or consequential losses and therefore Excluded Damages within the meaning of the contract's exclusion of liability clause.[110] In effect, even though Nova knew of the special circumstances for which Union Carbide (and then Dow) required the ethylene — to make polyethylene — the fact that the production of polyethylene was a step removed from the contract made these losses consequential, or indirectly related, to the breach of contract. Dow's lost profits from polyethylene sales were the knock-on effect of Nova's breach of its obligation to supply Dow with the agreed amount of ethylene.

The majority's approach has significant appeal. It acknowledges that "consequential damages" is a commonly used contractual term and is not, in fact, a term derived from the common law, and it proposes a solution founded in contractual interpretation. The majority of the Court of Appeal looked at the bargain itself, not the party's further purposes for which the bargain was struck. Ethylene was an interim product for which Dow had no use, except as a component in its polyethylene production.[111] Accordingly, Nova *did* have knowledge of special circumstances that would make Dow's loss of polyethylene production foreseeable. The majority of the Court of Appeal, however, rooted its analysis in the language of the contract, which only dealt with the production of "Products", being ethylene and "all liquid and gaseous hydrocarbons. . .. Produced at the Plant". While the parties may have contemplated that Dow would use the ethylene to produce polyethylene, the Operating and Services Agreement did not. Dow's "direct damages", then, were those associated with the subject matter of the contract — if a downstream product is not the "Product" for which the contract was written, downstream profit losses constitute consequential damages.

The majority's decision, however, can also be explained through *Hadley*. Dow's direct damages — those associated with the subject matter of the contract — were the losses that any purchaser of ethylene would suffer. These Ordinary Circumstance Losses are objectively foreseeable. Nova, however, knew that Dow's only use for the ethylene was to produce polyethylene which it would later sell. These losses were reasonably

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[110] The Court of Appeal referred the calculation of damages to the trial court, which proceedings are still ongoing.

[111] *Dow Chemical*, *supra* note 4 at para 53.

foreseeable in the special circumstances communicated between the parties. The Special Circumstance Losses, therefore, would include lost profits from the sales Dow could not make. Nova, however, did not accept the risk of the Special Circumstance Losses and excluded its liability for such losses as Excluded Damages.

In dissent, Antonio JA maintained that to limit direct losses to ethylene was to treat the parties' joint venture as a purchase and sale agreement for ethylene, contrary to their intent. The agreement was intended to enable the parties to jointly create their own ethylene for the ultimate purpose of making polyethylene. Therefore, any profit derived from polyethylene sales was "not indirect or consequential" but was actually "the direct profit anticipated by parties" and "the core reason" for their partnership.[112] As a result, the minority of the Court of Appeal would have affirmed the trial decision and included Dow's downstream profits as direct damages.[113] While this outcome would make sense if the only question was whether these lost profits fall in the second branch of *Hadley* (that is, that they constitute Special Circumstance Losses), it ignores the contractual allocation of risk between the parties and, more specifically, the exclusion of liability for Excluded Damages. If the lost polyethylene sales were direct losses, what did Nova intend to exclude as consequential losses, including lost profits?

3.3.2 *Sunsource v. University of Windsor*

The Ontario Superior Court adopted the majority of the Alberta Court of Appeal's approach in *Dow Chemical* in *Sunsource v. University of Windsor*[114]. This dispute arose out of a research contract between the plaintiff, Sunsource Grids Inc. ("**Sunsource**"), and the University of Windsor. Sunsource sought compensatory and punitive damages for alleged breach of contract, misrepresentations, and intentional unlawful interference with economic relations. The project at issue concerned pre-commercialization experimental research relating to a seamless power switching concept for solar PV and electrical grids.[115] The University agreed to supply a complete solar PV grid-mimicking hardware-based prototype at the end of the project period, supported by Sunsource's labour and equipment.[116] The University did not build the prototype, apparently because Sunsource failed to fulfil its end of the bargain by providing the necessary components.

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[112] *Ibid* at paras 195-97.
[113] *Ibid* at para 200.
[114] *Sunsource*, *supra* note 5.
[115] *Ibid* at paras 1-2.
[116] *Ibid* at para 8.

Sunsource alleged that the University's failure to provide the prototype and other alleged misconduct, prevented it from commercializing the switch concept. It sought millions in damages for the "total loss of the value" of its business. The University maintained that any such damages constituted "consequential damages" barred by the governing exclusion clause.[117]

The Court held that Sunsource had not established any breach but nevertheless assessed the question of damages in the event of judicial error.[118] The Court held that Sunsource's business losses would not have arisen in the "usual course", given the nature of the research contract and the speculative assumptions on which Sunsource's claims of commercial success rested.[119] There was, however, evidence that the parties had anticipated that loss of future profits could arise from a breach, though not a total loss of Sunsource's business.[120]

The Court held that the total loss of Sunsource's business constituted "consequential losses" for which the University could not be liable under the agreement's exclusion clause.[121] In arriving at this conclusion, the Court applied a variety of reasons.

First, it concluded that any loss of future profits was "entirely contingent on the plaintiff's successful performance of significant activities that were beyond the scope of the subject matter of the contract and the University's performance obligations". Such losses were not "direct and immediate" results of the University's failure to deliver the prototype, but instead constituted "indirect and mediate consequences that are substantially removed from, and downstream to, any breach".[122] This use of the term "mediate" suggests the Court here was applying causative reasoning.[123] This is supported by the Court's subsequent finding that the "ordinary objective meaning" of "consequential" is:

> [A] result that does not flow directly and immediately from an act, but rather as an indirect or mediate result of the primary act... . [C]onsequential damages are awarded to compensate for loss or injury that does not flow directly and immediately

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[117] *Ibid* at paras 27-28.
[118] *Ibid* at para 857.
[119] *Ibid* at paras 882-90.
[120] *Ibid* at paras 898-910.
[121] *Ibid* at para 1211.
[122] *Ibid* at para 1212.
[123] See *Merriam-Webster.com Dictionary*, (2024), sub verbo "Mediate" defined as "exhibiting indirect causation, connection, or relation."

> from an act of the party, but only from some of the consequences or results of such an act.[124]

Sunsource's lost profits constituted "consequential" and not "direct" damages because the performance of the research agreement would not have positioned Sunsource to earn revenue or commercialize its product.[125] Much more would be required — all of it outside the scope of the contractual obligation undertaken by the University. This sounds like the McGregor characterization of consequential losses as those losses which occurred as a result of some additional event, making this class of damages, while reasonably foreseeable, downstream losses.

The Court agreed with the approach taken by the Alberta Court of Appeal in *Dow Chemical*, to avoid equating consequential damages with the second branch of *Hadley*; and to focus on the subject matter of the contract, in light of the contract as a whole and the parties' intentions.[126] Applying *Dow Chemical's* reasoning, the Superior Court concluded that, assuming there had been a breach of contract, Sunsource's direct damages were the loss of value of the prototype that was not supplied. Any additional loss was indirect and consequential, and therefore within the scope of the exclusion clause.[127] This conclusion arose from the nature of the research agreement, and the Court acknowledged that in some cases, lost future profits could very well constitute direct damages.[128]

Thus, the Ontario Superior Court applied *Dow Chemical* to reach a conclusion that accorded with the common-sense business interpretation of the parties' agreement.

4. WHERE WE GO FROM HERE

The courts' focus on contractual interpretation in *Dow Chemical* and *Sunsource* makes a great deal of sense. It separates foreseeability at common law from the definition of the commercial term "consequential damages" and it interprets both in light of the nature of the agreement and the parties' manifest intentions, thereby bringing the analysis back to the fundamental principles of contract law. As *Dow Chemical* demonstrates, however, even a well-reasoned analysis can lead to differing conclusions[129] when the parties fail to make their intentions

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[124] *Sunsource*, *supra* note 5 at para 1224.
[125] *Ibid* at para 1234.
[126] *Ibid* at paras 1243-44, 1247.
[127] *Ibid* at para 1247.
[128] *Ibid* at paras 1251-60.
[129] Indeed, four judges, in three sets of reasons anchored in the relevant case law, reached their own conclusions.

clear in the contract itself, leaving the court to grapple with which losses, in the universe of recoverable losses, the parties allocated between themselves.

The goal of business parties must be to take control of delineating their risk allocation, particularly when one party intends to exclude its liability for losses for which it would ordinarily be required to pay damages. This means moving away from the term "consequential damages" and instead moving towards communicating intentions with clarity and specificity, so as to minimize the risk that any judicial opinion will misinterpret the manner in which parties determined to arrange their relationship. As should be abundantly clear by now, exclusion of liability for loss provisions in any contract should never be seen as mere boilerplate. Rather, clauses that limit or exclude losses must be carefully drafted to take into account the actual losses that the parties might incur if the contract is not performed as agreed and which of those risks each party are prepared to accept (and for which they are prepared to compensate the other side).

Some contracts may attempt to avoid the entire debate by addressing all breaches through liquidated damages and indemnity provisions as the exclusive remedy of the parties in the event of a breach. These liquidated damages or indemnity obligations may even be capped at a certain value or percentage of the value of the contract price. Where this is not appropriate, and the parties wish to retain their right to claim damages, but also to ringfence liability to what they see as being the direct (or most immediate) losses, at least two solutions present themselves.

One approach would be for the parties to provide their own clear definition of "consequential damages" in the contract itself and then exclude liability for those losses. Any definition should precisely delineate the types of loss that fall within the scope of the term. The danger in this is that a court may still presume that the parties must have meant something more in using the word "consequential" and try to reconcile the clear definition with prior interpretations of the word, including the historic tendency to place consequential losses within the *Hadley* framework. Also, as *Dow Chemical* makes abundantly clear, reasonable minds may differ on precisely what losses are direct and which are further removed or knock-on effects of the original breach.

The term "consequential losses" carries with it significant legacy and baggage. As lawyers, whose craft it is to crystalize our clients' intentions and agreement in writing, we can do better. We do our clients no service at all by relying on boilerplate exclusion clauses on the assumption that the term "consequential losses" is judicially understood, and that the

particular formulation of exclusionary language has been judicially tested. The assumption that the courts know what we mean by "consequential and indirect losses" is clearly unwarranted.

A second, and better, approach would be for the parties to clearly define the limits of the risks that they are prepared to accept and the losses for which they will not compensate the other party. Lost profits may, or may not be, depending on the context, consequential losses as understood in reference to the second branch of *Hadley*. If one party does not want to be responsible for losses extending to lost profits, its lawyers should not rely on the term "consequential damages" to achieve that allocation of risk. Instead, expressly exclude your client's liability for any and all lost profits or impose a damages cap that reflects the risk that the non-performing party accepts. We think that this is preferable. Consider the outcome if Nova had clearly stated that its liability if it failed to produce and deliver ethylene to Dow would be limited to Dow's cost of finding an alternative source of ethylene and would not include any amount on account of Dow's losses arising from its inability to produce polyethylene, including any lost profits from its subsequent sale of polyethylene.

Whatever you do in drafting risk allocation clauses, take a proactive approach, and signal the parties' intended meaning so that litigators and courts are not struggling to piece together the parties' intentions years later and through great expense.