

Assessing the consequences

Dispute Perspectives

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Given recent challenging economic conditions it is perhaps unsurprising that we are seeing an upturn in claims including elements of consequential loss, as claimants seek to recover the full impact of contractual breaches on their business and reputation.

Claims for consequential loss are often beset by uncertainty and complexity and can pose particular challenges for the parties, their lawyers and for the quantum expert. A key challenge is forming a view as to what is attributable to the breach, albeit indirectly, and what is attributable to other factors such as market conditions and industry trends.

In this Dispute Perspective, we explore the issues and consider some of the implications for case strategy and quantum assessment. The references to legal cases herein are presented only to frame the background to consequential loss issues and should not be construed as legal advice.

What are consequential losses?

The majority of legal frameworks allow for losses arising naturally from the breach of contract itself to be recoverable. This would include for instance the direct cost attributable to replacing an undelivered or malfunctioning piece of equipment, or the replacement labour and materials cost for incomplete building works.

Depending on the applicable legal framework it may also be possible to claim for losses over and above these "natural" losses. Consequential losses – if defined as being the "probable result" of a breach, rather than "arising naturally" from it – would fall within this latter category. Typically it is necessary to show that such damages were reasonably foreseeable or within the contemplation of the parties at the time of contract formation.

One critical point worth recognising at the outset is that the value of claims for consequential losses often far exceed those for the "natural" losses, with all the psychological impact on the minds of claimants & respondents that this implies.

Where the economic environment causes investments to fall short of expected yields, where capital projects are delayed or terminated or contracts breached, so consequential losses flow. The uncertainties inherent in such losses raise issues for case strategy, evidence and quantum.



Strategy and evidence

Whether the Claimant can claim consequential losses as a probable result of the contractual breach depends, of course, on the facts of the case (indeed some contracts specifically exclude consequential losses) and the applicable legal framework. It is, however, an area where early consideration of case strategy with the quantum expert can assist.

Consider the following example

A computer company contracts to acquire an operating system (Contract A) to use in the performance of a contract it has entered into with a third party (Contract B). The system supplier is aware of the necessity of its use in Contract B – indeed, the contracts are linked. In the event, the operating system fails. The company incurs additional costs in an attempt to resolve the issues, but these efforts are unsuccessful and Contract B is terminated by the third party. The computer company is therefore unable to earn its expected profit.

The company also intended to use the operating system in future sales to other third parties. With that in mind, a number of existing employees have spent considerable time developing applications to be used with the new operating system. Those applications are now of no value. Finally, a number of new orders have been cancelled and certain existing customers have failed to trigger upgrade clauses in their contracts. The company's view is that this is a result of the reputational damage caused by the adverse publicity following the cancellation of Contract B.

The company in the example will look to a claim based on its overall loss due to the failure of the operating system. This would compare its actual profits (or losses incurred) with those profits which were anticipated but for the breach – the so called “but for” scenario. This would almost certainly include elements which the system supplier might argue did not arise as a direct result of a breach, and cannot reasonably have been in the contemplation of the parties as its probable result. And which therefore, depending on the applicable legal framework, may not be recoverable.

The Claimant should therefore seek to ensure that the more direct elements of the loss claimed – the additional costs incurred in attempting to resolve the operating system issues and the loss of profit on Contract B – are separately identified and quantified in its claim. For elements of the loss likely to be considered to be consequential – the loss of additional third party sales, or the cancellation of new orders and upgrades – it will be important for the company to

demonstrate, where possible, that these losses are linked to the contract cancellation and may reasonably have been contemplated by the parties at the time the contract was entered into. Any evidence of discussions and correspondence between the parties during the negotiation of the contract would obviously be helpful, together with details as to the reasons why customers cancelled or deferred planned upgrades.

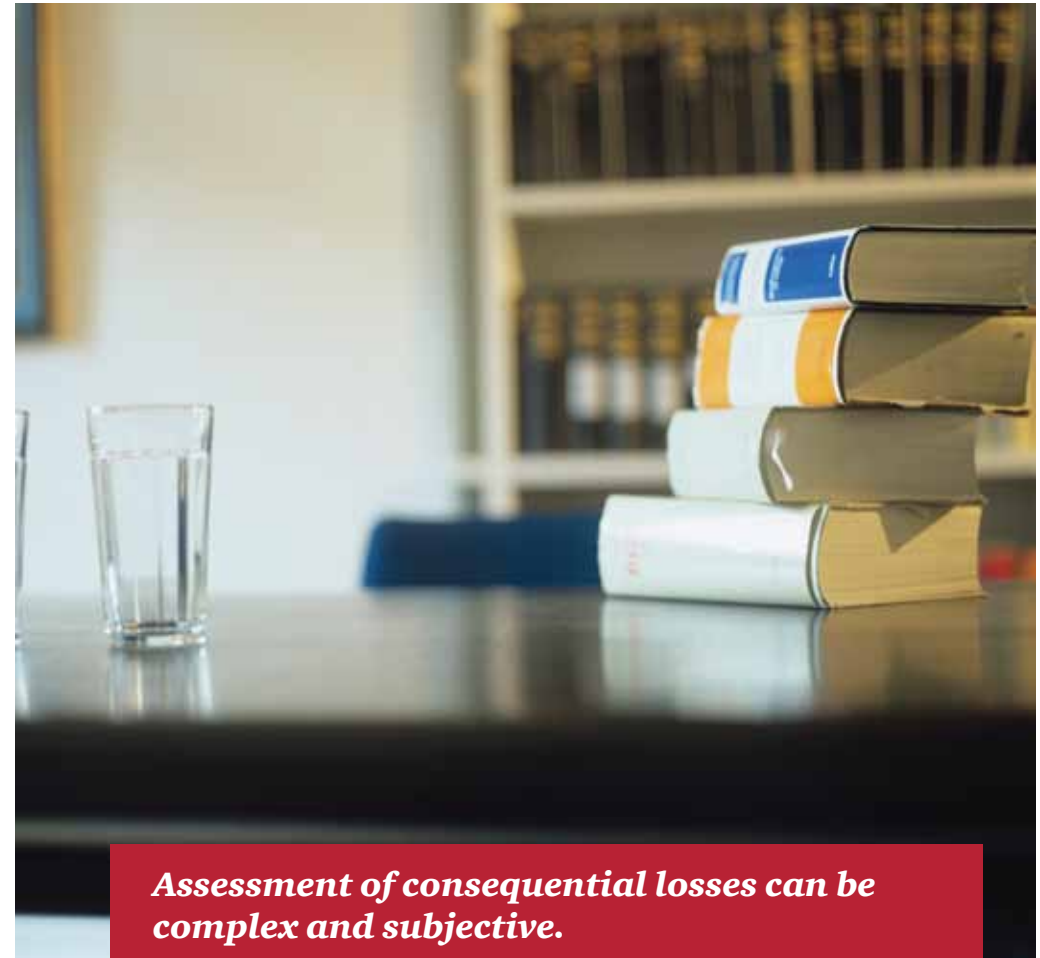
The involvement at this stage of an expert with experience of the assessment of consequential loss claims will assist with determining the scope of the claim, particularly with regard to the causal link to lost sales and to identification of relevant categories of incremental costs and the evidence required to support those costs.

Extending the example, the contractor may present a counterclaim arguing that the failure of the operating system is partly or entirely attributable to the computer company. Any such claim may also include elements of consequential loss that would also need to be quantified.

Quantum issues

Assessment of consequential losses can be complex and subjective. Key issues on which the expert will need to form a robust view at an early stage in the consideration of the claim include the following:

- 1) Is the consequential loss attributable to the alleged breach of contract or are other factors responsible? In our example, could the cancellations of new orders and upgrades be attributable to a downturn in general market conditions which lead customers to cut back on non-discretionary expenditure? Did the competitive landscape change and is the company losing sales to new competitors entering the market?
- 2) How realistic is the "but for" scenario? If the claim is based on the company's sales and profit forecasts prior to the breach, how reasonable are the assumptions underlying those forecasts? This will in turn involve a review of the company's forecasting track record and the broader industry growth trends. If the company is a manufacturer, did it have the production capacity available and necessary to achieve forecast increases in sales?
- 3) Are the costs claimed genuinely incremental? Or are these merely reallocations of fixed costs which the company would have incurred irrespective of the breach of contract? In our example, it seems clear that the costs incurred in attempting to resolve the operating system problems are directly linked to the breach. However, any assessment of the employee costs incurred in developing applications to be used with the new operating system (whether as part of the consequential loss claim or an alternative wasted costs claim) would need to consider carefully the following: (1) would the relevant employees have been made redundant if they had not been working on tasks related to the new operating system; and (2) would the employees have generated value for the company which was at least as great as the costs of their employment by working on other activities?



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Challenges common in the Middle East and arising from recent global economic turbulence

The business environment in the Middle East and the turbulent economic times experienced globally over the past few years both present challenges in the assessment of consequential losses.

In our experience the following are important considerations:

1) Is there adequate documentary evidence available in support of the claimed losses to enable an expert to form an independent view?

Our experience in the region is that the adequacy of documentation can be a challenge, particularly where companies have grown quickly and/or do not have mature business support functions or information systems. The type of shortfalls we have experienced include a lack of sufficiently detailed accounting records, reliable business projections and other such information that would help to evidence a claim for losses. In any assessment of loss, assumptions will have to be made based on the available evidence and these are likely to be an area of focus for any expert engaged by the other party.

2) Is it possible to isolate and identify the profits lost as a consequence of the breach as opposed to broader market conditions?

This can be particularly challenging in times of economic turbulence such as those experienced in late 2008 and the first half of 2009 (a period in which a number of disputes currently being played out had their genesis). One tool available to the expert in establishing the “but for” scenario is to compare the performance of the Claimant with comparable companies operating in the same market in the same economic conditions. A common challenge of performing such analysis in the Middle East is that many large companies in the region are privately held. As such the lack of public reporting and disclosure requirements means there is limited publicly available information on such companies in the region. However, listed companies have greater public reporting and disclosure requirements and are therefore more useful for comparison. The expert needs to use benchmarking, industry sector data and economic data to derive the ‘but for’ scenario.

3) If the calculation of loss requires a company to be valued, what is the appropriate basis of valuation? Should the valuation be undertaken on the basis of market value, fair value or economic value?

The choice of valuation methodology, particularly in volatile markets, is critical as different bases may generate very different values:

- Market value focuses on the value that might be achieved in the open market for the business. In the current climate this may be quite heavily discounted due to the shortage of willing buyers and funding constraints.
- Fair value considers value from the perspective of that which is equitable between the parties, and is often used in shareholder disputes or where there are minority interests.
- Economic value represents the value of the business to the current owner and seeks to value the business by reference to its intrinsic qualities, its ability to generate earnings, rather than being overly influenced by current market sentiment.

The quantum expert will decide on the most appropriate valuation methodology(s) to apply in the particular circumstances of a claim.

4) What is the appropriate valuation date and how will this impact the valuation of loss?

Recent market volatility means that company valuations and profit forecasts can shift significantly depending on the appropriate valuation date. If a breach occurred pre-crisis, does the applicable legal framework allow for the use of hindsight in assessing the value of losses at the date of the breach? If not, the valuation of losses may be based on the profits that were forecasted before the economic downturn, which will generally be higher than the actual profits that were earned during the economic downturn. These considerations can therefore have a significant impact on the valuation of loss.

Conclusion

The issues raised by consequential losses have implications for case strategy, including the approach to evidence and quantification of losses. Early consideration of these issues between the claimant, counsel and quantum expert will assist both in setting the scope for a realistic claim including consequential loss, and in determining at an early stage the evidence necessary to support the “but for” scenario.

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