Back to the Future: The Impact of Post-Breach Events on Damages

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Introduction

The English law of damages for breach of contract is founded upon the compensatory principle: that damages should place the claimant in the same situation with respect to damages as if the contract had been performed (*Robinson v Harman* (1848) 1 Exch 850).

That would imply a simple comparison, between the claimant's actual financial position and the position the claimant would have been in if the contract had instead been performed with the claimant being entitled to the difference. But so simple a calculation has the potential to deliver a result which goes beyond what most people would consider compensation. As Kramer puts it (*The Law of Contract Damages* (2014)):

"Just because I wrongfully sacked an employee and gave him a lot of free time, should I really compensate him because during that free time he took up gambling and frittered away his money? Or because [he] *took a walk and was struck by lightning? Or if he passed up an even better job the next day?"*

In each case, the loss (gambling losses, injury by lighting, loss of employment income) would not have been suffered "*but for*" the breach of contract and so can be said to have been caused, as a matter of fact, by the breach. For a loss to be recoverable, such "*factual*" causation is necessary, but it is not sufficient.

When the loss that is being claimed can *also* be said to have been caused, or exacerbated, by the claimant's own unreasonable conduct or inaction post breach, it ceases to be recoverable. The claimant's own subsequent unreasonable action (e.g. turning down the better job) is said to "*break the chain of causation*". When we speak of a "*duty*" to take reasonable steps to mitigate, this is what is being referred to - that one cannot recover for losses which one could have avoided by acting reasonably (see e.g. *Standard Chartered Bank v Pakistan National Shipping Corp (No 3)* [2001] EWCA Civ 55 paragraph 41 Per Potter LJ).

In a typical case, the result is that the defendant will argue that the claimant acted unreasonably, and that the losses claimed (or some part of them) could have been avoided. The claimant will argue the contrary.

There is, however, the odd case where the question is not whether a loss could reasonably have been avoided, but whether a gain or benefit which the claimant has received, and which they would not have received "*but for*" the breach, must be accounted for. These cases can generate some interesting hypotheticals. Consider the example of the gambling losses. It seems natural to say that to spend one's new found free time gambling is unreasonable, and so the losses that result should not be recoverable. But what if the employee had, instead, used his new found free time to gamble *successfully*, and so make a huge profit? Or suppose he had engaged in some other similarly risky venture which he would not otherwise have been able to take part in, but which (in the event) rendered huge rewards?

Fulton Shipping Inc of Panama v Globalia Business Travel SAU [2015] EWCA Civ 1299 is a decision of the Court of Appeal from 2015 which considered the question of when a benefit had to be accounted for. Specifically the case concerned whether the innocent party had to give credit for an additional $16.7 million that it recovered when forced to sell a vessel following an early redelivery by charterers, in breach of contract, compared to what it would have received if the ship had been sold on the contractual redelivery date. The High Court proposed a list of principles for such cases, said to have been distilled from the authorities, but this was disapproved by the Court of Appeal. The Court of Appeal said the question was a simple one. In this article, we look at the case and what (if anything) can be drawn from it as to when benefits must be accounted for.

A fortuitous sale or a case of lost profits?

The "*New Flamenco*" was a small cruise ship built in Genoa in 1972. In February 2004 she was chartered by the Claimant, Fulton Shipping Inc., (the "**Owners**"), to the Defendant, Globalia Business Travel SAU (the "**Charterers**"). There was then a dispute between the parties about the term of the charter that had been agreed. The Owners argued that the charterparty expired on 2 November 2009. The Charterers insisted that the term expired on 28 October 2007. When it became clear the dispute could not be resolved, the Owners treated the Charterers as being in anticipatory repudiatory breach. In August 2007, they accepted the breach as terminating the charterparty. The Charterers, in accordance with their own interpretation of the agreement, then redelivered the vessel on 28 October 2007. Shortly before that date the Owners entered into an agreement with a third party for the sale of the ship, for $23,765,000.

The charterparty was governed by English law and provided for London arbitration. The Owners commenced arbitration and a sole arbitrator was appointed on 4 March 2008. Claim submissions were served after a long delay on 23 November 2011, and a hearing took place in May 2013. By the time of the hearing, it was apparent that there was a significant difference in the value of the vessel in October 2007, when the Owners had sold it, and the value it would have had in November 2009, when the *New Flamenco* would have been redelivered to the Owners had the Charterers performed the charterparty. The collapse of Lehman Brothers in September 2008 and the ensuing global financial crisis had occurred in the meantime. The value of the vessel if she had been redelivered in November 2009 would, the arbitrator found, have been only $7 million - over 70% less than what the Owners had sold her for.

Undeterred by their apparent lucky escape, the Owners claimed just over $11 million for the additional hire they would have earned if the vessel had been redelivered in November 2009. In return, the Charterers argued that the Owners were bound to bring into account and give credit for the difference between the amount for which the vessel had been sold in October 2007 and her value in November 2009. That difference was so large ($16,765,000) that giving credit for it would extinguish the Owners' claim for damages for the Charterer's alleged repudiation. The Owners said that the difference in value was irrelevant as a matter of law, and did not fall to be taken into account.

The arbitrator found that the sale of the vessel by the Owners in October 2007 was caused by the Charterers' breach. It was in reasonable mitigation of the loss they faced at that time. He pointed out that the facts were quite unusual. It is not very often that it will be found reasonable to sell a vessel on premature termination of a time charterparty. The usual practice would be to find a new charterer and hire the vessel to them for the rest of the charter period. In such a case, the owner's loss is the difference between the new charter rate and whatever would have been paid under the original contract. Neither party could find an authority directly on point. But the Charterers had accepted that there had been no alternative substitute two year time charter, and that the sale of the Vessel was reasonable in the circumstances. The arbitrator concluded:

"… there is no reason why capital savings could not and should not be brought into account in considering the net loss suffered by the Owners".

The Owners had therefore achieved a Pyrrhic victory, winning the argument on liability but recovering no damages. The Owners appealed to the High Court, arguing that the arbitrator had made a mistake in law by taking into account the fall in capital value of the Vessel after it was sold in the calculation of the Owners' damages.

The rival contentions as to what amounted to a 'benefit' as a matter of law

The Owners raised two main arguments as to why the fall in capital value of the Vessel should not be taken into account for the purposes of the rules of mitigation.

First, the Owners argued that a benefit to the innocent party arising out of a breach of contract does not fall to betaken into account unless it is of the same character as the loss for which he is claiming. Thecapital value of the vessel is different in kind from the type of loss recoverable for acharterers' breach of a time charter (the loss of an income stream) and should therefore be ignored.

Second, on the facts, the Owners said that the benefit was not sufficiently causally linked to the breach. The Owners said that causation had to be established directly between breach and benefit, not merely between breach and mitigating step and then between mitigating step and benefit.

The distinction was relevant on the facts because the Charterers accepted that the mitigating step (the sale of the vessel) was reasonable and had sufficient causal connection with the breach. They could hardly argue otherwise - since no one else wanted to hire the ship, selling it prevented the Owners from incurring further running costs, or lay-up costs, and therefore reduced the loss of income the Owners suffered as a result of the Charterers' breach.

The Owners argued that insofar as the sale had beneficial consequences in respect of the capital value of the vessel, these were not themselves 'causally linked' to the breach. It was not permissible, they argued, to say simply that the sale was caused by the breach, and the benefit resulted from the sale. The benefit was too far removed from the breach, in causal terms, and should not have been taken into account in calculating the Owner's loss.

The Charterers responded that the straightforward principle, which should be applied, was simply that the benefit should arise out of the consequences of the breach (a question of fact). According to them, the test proposed by the Owners was unnecessarily elaborate and artificial. They denied the existence of a rule that a benefit must be the 'same kind of loss' as is being claimed for in order to be taken into account for the purposes of mitigation; no such principle could be derived from the authorities. What the Charterers were saying was that the matter was all to do with the net financial position arising out of the same transaction or relevant asset, which is what the compensatory principle is concerned with.

In fact, both parties prayed in aid the compensatory principle - that damages for breach of contract are intended to put the innocent party in the same financial position as if the contract had been performed. However, Popplewell J pointed out that in order to determine how to reach that hypothetical position one must first work out what losses were factually and legally caused by the breach, and whether those losses are too remote. The issues of causation and mitigation must be addressed first.

The principles laid down by the High Court

Popplewell J's starting point was the well-known 'third rule' of mitigation, summarised in *McGregor on Damages* (18th Edition) as follows:

"… (3) The third rule is that, where the claimant does take steps to mitigate the loss to him consequent upon the defendant's wrong and these steps are successful, the defendant is entitled to the benefit accruing from the claimant's action and is liable only for the loss as lessened … provided that the benefit gained is not to be regarded as collateral."

It is well established that not all benefits accruing to an innocent party resulting from mitigating steps are taken into account to lessen that party's entitlement to damages. The classic example of a benefit not taken into account is insurance proceeds paid out to the innocent party as a result of the wrongdoer's actions. An insurance policy may fully compensate the innocent party for its loss, but that does not reduce the amount the wrongdoer must pay.

Two reasons are often advanced for refusing to account for such benefits. First, if a benefit is not caused by the wrongdoer's actions, there is no reason to take it into account to reduce the wrongdoer's liability. The insurance proceeds are not a benefit caused by the actions of the wrongdoer because they flow from the contract of insurance which provides for them to be paid on that contingency. The innocent party was prudent in taking out insurance, and that is a matter that does not concern the wrongdoer. The other reason is one of policy: it would be contrary to fairness and justice that the wrongdoer should get the benefit of an insurance for which the innocent party has paid.

Popplewell J then turned to the authorities for guidance. The leading authority on mitigation remained the decision of the House of Lords in *British Westinghouse Electric and Manufacturing Co Ltd* v *Underground Electric Railways Co of London Ltd* [1912] A.C. 673. In that case the defendants agreed to supply eight steam turbines to the plaintiffs for use in the London Underground. The turbines failed to meet the efficiency requirements in the contractual specification. The plaintiffs used them for several years, and then replaced them with Parsons machines, which were much more efficient than required by the contract.

The plaintiffs claimed £42,000 in respect of the losses caused by the inefficiencies of the machines prior to replacement; and £78,186 for the cost of the Parsons machines. The issue which came before the court, by way of a special case stated by an arbitrator, was whether the plaintiffs were bound to give credit for the savings due to the Parson machines' superior efficiency over what the defendants had contracted to supply. The House of Lords held that they were.

Popplewell J set out several quotes of Viscount Haldane LC, who gave the leading speech, giving guidance on in which circumstances benefits accruing to the innocent party should be taken into account:

"… provided the course taken to protect himself by the plaintiff in such an action was one which a reasonable and prudent person might in the ordinary conduct of business properly have taken, and in fact did take whether bound to or not, a jury or an arbitrator may properly look at the whole of the facts and ascertain the result in estimating quantum of damage.

… The subsequent transaction, if to be taken into account, must be one arising out of the consequences of the breach and in the ordinary course of business."

It was clear to Popplewell J from these remarks that, contrary to the argument of the Owners, a benefit to the innocent party arising out of a breach of contract can betaken into account even if it is a 'different kind' of loss than he is claiming for. This follows from the broad language used, in particular "*an arbitrator may look at the whole of the facts*". It was therefore not determinative that the benefit in question was capital not income. Popplewell J did find, however, that a difference in kind between the loss and a benefit may be indicative that the benefit is not legally caused by the breach.

The remainder of the judgment focused on whether the benefit was sufficiently 'causally linked' to the breach. Popplewell J undertook an expansive review of the authorities on mitigation and distilled the following principles:

"Whilst a mitigation analysis requires a sufficient causal connection between the breach and the mitigating step, it is not sufficient merely to show in two stages that there is (a) a causative nexus between breach and mitigating step and (b) a causative nexus between mitigating step and benefit. The inquiry is also for a direct causative connection between breach and benefit, in cases approached by a mitigating analysis no less than in cases adopting a measure of loss approach ... Accordingly, benefits flowing from a step taken in reasonable mitigation of loss are to be taken into account only if and to the extent that they are caused by the breach.

<u>Where, and to the extent that, the benefit arises from a transaction of a kind which the innocent party would have been able to undertake for his own account irrespective of the breach, that is suggestive that the breach is not sufficiently causative of the benefit</u> …"

Applying these principles to the facts of this case, Popplewell J held that there was no "*direct causative connection*" between the benefit of the fall in capital value of the vessel and the breach of contract by the Charterers. The difference in value of the vessel was not caused by the Charterers' breach but by the fall in the market which occurred irrespective of such breach. The capital benefit was caused by the Owners' independent decision to realise the capital value of their asset.

Popplewell J was reinforced in this view by the fact that the Owners could have sold the vessel at any time, irrespective of the breach. He found that the independence of the Owners' ability to sell the vessel from the Charterers' breach of contract was another indication that there was an insufficient casual connection between the two.

The judge said he derived this principle from the case of *The Elena D'Amico* [1980] 1 Ll Rep 75, a decision of Robert Goff J, as he then was. In that case, it was the owners that defaulted on a charterparty, but the charterer refused to go into the market to fix a substitute vessel and instead claimed for the profits it lost by being unable to fulfil profitable trading. Goff J held that those lost profits were a result of the charterers' independent decision not to enter the market to fix a substitute vessel. The owners' liability was limited to the difference between the charter rate and the market rate for the remainder of the charterparty.

Popplewell J highlighted the fact that the charterers' decision whether or not to have a vessel under charter to fulfil the profitable trading opportunity was open to the charterers irrespective of the owner's breach (because an alternative vessel was generally always available in the market). He found that Goff J treated this as indicative of the causative independence of the mitigating step from the breach, and concluded:

"This suggests that one touchstone of whether a mitigating step is legally independent of the breach is whether it was one which was open to the innocent party in any event."

Popplewell J held that the arbitrator had made an error in law by his finding that the sale of the vessel was caused by the Charterers' breach, and that this was legally sufficient to establish the necessary causative link between breach and benefit. Having made these findings he overturned the decision of the arbitrator. The Owners appealed.

The Court of Appeal disagrees and boils matters down

Longmore LJ, who gave the leading judgment, began by saying that it was notoriously difficult to lay down principles of law in the realm of mitigation of loss, particularly when it is said that a benefit received by the innocent party is to be brought into account to reduce their loss.

In contrast to Popplewell J's expansive review of the authorities on mitigation, Longmore LJ referred to only one case before setting out the appropriate principle: *British Westinghouse*. He quoted from the same section of Viscount Haldane LC's speech, set out above, and also noted that the learned judge had made an exception for transactions that were "*wholly independent"* of the relationship of the parties. Longmore LJ concluded that the important principle which emerged was the following:

"… if a claimant adopts by way of mitigation a measure which arises out of the consequences of the breach and is in the ordinary course of business and such measure benefits the claimant, that benefit is normally to be brought into account in assessing the claimant's loss unless the measure is wholly independent of the relationship of the claimant and the defendant."

That principle was sufficient to guide the fact-finder in any particular case. No extra gloss was needed. He was critical of Popplewell J's causation principle as being "*somewhat elaborate*". Clarke LJ, in a short concurring judgment, described its application as "*elusive*". Whether the benefit "*arises out of the consequences of the breach*" is the only enquiry that needs to be undertaken.

Longmore LJ also criticised Popplewell J's principle that,where the benefit arises from a step that the innocent party would have been able to undertake irrespective of the wrongdoer's breach, this is suggestive that the breach is not sufficiently causative of the benefit. He said that this principle was based on a misreading of the *The Elena D'Amico*. Even if the decision not to take advantage of the available market in that case could be characterised as an "*independent decision*" that did not "*arise from the breach*", it did not follow that, if there was *no* available market, a decision to spot charter a vessel would be an equally independent decision not arising from the breach. It might be the only form of mitigation available.

Longmore LJ was reinforced in his view by an analogous charterparty case called *The Kildare* [2010] 2 Lloyd's Rep 360, in which the charterers repudiated a 5 year consecutive voyage charterparty after only 13 months had expired. At the time the owners accepted the repudiation (January 2009) there was no available market but an available market had revived by February 2010. The question was whether the owners were confined to their losses incurred by the actual trading (by spot fixtures) of the vessel for the duration of the consecutive voyage charter or whether they could take advantage (after February 2010) of the difference between the contract and the market rate.

Steel J said that the spot fixtures for the period January 2009 to February 2010 were not the outcome of any "*independent decision*" since no alternative form of mitigation was available; he distinguished *The Elena D' Amico* because in that case there had been an available market. He then held that the later decision not to take advantage of the market was also not a decision "*independent of the wrongful termination*". It was only acceptance of the market rate at the date of breach that was deemed to constitute reasonable mitigation.

Longmore LJ reasoned that, where there is no available market, there is no difference in principle between fixing a spot charter and selling the vessel, if that is the only form of mitigation available. Put another way, if the Owners had been able to continue to let the vessel over the remaining (unexpired) two years of the charterparty, they would have had to give credit for any profits they might have made. The Court of Appeal did not think that profits generated by selling the vessel should be treated any differently. Both decisions, continuing to trade the vessel or sell it, can result in a benefit to the owner that arises out of the consequence of the breach, and which must be taken into account in considering an owner's net loss.

Conclusion

Longmore LJ concluded by saying that it was a "*common sense overall judgment*" whether there was a sufficient causal nexus between the breach and any profit or loss. The experienced maritime arbitrator the parties had chosen to resolve their dispute was the person best placed to make that judgment, and he had made no error of law in doing so. The judgment of the arbitrator was, therefore, restored. The addition of an elaborate test of legal causation to an already complicated factual enquiry would lead to legal uncertainty and encourage further disputes. It is now clear that the courts, and arbitrators applying English law, will be even more reluctant to accept elaborate legal arguments on the correct application of the long-standing principles of mitigation set out in *British Westinghouse*.

The overriding principle remains that damages should be compensatory. Longmore LJ noted that:

"It was, in the end, considerations of fairness and justice that persuaded the arbitrator that, when he looked at the case as a whole, the Owners had made a considerable profit from the action they took by way of mitigating what would otherwise have been an undoubted loss. That profit arose from the consequences of the breach and should therefore be brought into account."

The Owners sold the ship in 2007 in order to avoid the lay-up costs which they were incurring because of the premature termination of the hire. Given that was their motivation, the sale was a step taken in mitigation, and fell to be taken into account, thereby wiping out the $11m claim for 2 years lost hire.

In practice, the key question in these kinds of cases (premature termination of hire, and sale of the asset) seems to be: what was the motivation for the sale? It can be seen that one does not need to change the facts very much in order to render an entirely different result. Suppose, instead, that the Owners could show that they would *always* have sold the ship in 2007, with or without the charter in place. The Owners' claim would then seem to be for the difference between: (i) the $23,765,000 they sold the ship for with no charter in place; and (ii) whatever they could have sold the ship for in 2007 with a charter in place (presumably more, if the charter rate exceeded the contemporaneous market rate). The facts are almost identical - all that differs is the Owners' motivation - but the result is potentially very different.

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