

LIMITATION OF LIABILITY DISCUSSION PAPER

Aim

1. This is an updated version of the Defence Discussion Paper that was initially circulated on 27 February 2008 (first draft) and then again on 29 June 2008 (second draft). The revisions take into account comments received from Defence stakeholders on the draft Discussion Papers, from participants at the Liability Review Forum, from Defence Procurement Network stakeholders and from the Australian Industry Group (AIG).
2. The aim of the Discussion Paper is to set out an approach to risk management that could assist Defence and industry to formulate appropriate liability regimes for Defence. The purpose of the paper is to stimulate discussion amongst stakeholders internal and external to Defence and within industry. It is intended that references to Defence throughout this paper be taken to be inclusive of all Defence organisations, including the Defence Materiel Organisation.

Background and Proposed Approach

3. CEO DMO and the Australian Industry Group (AIG) have been consulting on how Defence and Defence industry can best work together to improve procurement processes. During recent discussions with AIG the issue of Defence's liability regime was raised, notably standardising and benchmarking the regime.
4. In particular, in order to improve the process, AIG sought to work together with the Commonwealth to review the:
 - Commonwealth's approach to risk assessment in the context of allocating liability;
 - determining liability clauses in requests for tender;
 - evaluating tender responses;
 - negotiating liability clauses;
 - applying liability clauses during contract; and
 - dealing with limitation of liability clauses in Simple procurement activities.
5. Defence and AIG have agreed to establish a joint working group to review Defence's current liability regime. The members of the joint working group are:

AIG:

- Geoffrey Dewick, Saab Systems;

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- David Mahony, BAE Systems;
- Scott McGeechan, Codarra Advanced Systems;
- Michael Jackson, Thales Australia;
- Kayvan Payman, Boeing Australia;
- James Souter-Robinson, Raytheon Australia; and
- Liam Wallace, ASC Ltd.

Defence:

- Harry Dunstall, Special Counsel to CEO DMO, DMO;
- Willem Bouwer, Executive Director Procurement Policy, DMO;
- Grey Lynch, Acting Director ASDEFCON, DMO;
- Richard Matchett, Assistant Director Procurement Policy, DMO;
- Thea Huber, Director of Strategy and Standardisation, Electronic Systems, DMO; and
- Bob Baird, Director Construction Contracts, Defence Support Group.

6. Defence has also established a wider virtual group for internal consultation.
7. AGS will also attend working group meetings as legal advisers to Defence.
8. The Defence and Industry working group members intend to meet to draft a further position paper based on this Discussion Paper. This may take a number of meetings over a period of months.
9. The position paper may include an updated Defence risk assessment regime in relation to limitation of liability, and updated *Defence Procurement Policy Manual* (DPPM) liability chapter and draft ASDEFCON suite clauses.
10. For these purposes two smaller working groups have been established as follows:

Liability Working Group

- Harry Dunstall
- Grey Lynch
- Linda Richardson
- Geoffrey Dewick
- Michael Jackson

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— David Mahoney

Insurance Working Group

— Harry Dunstall

— Grey Lynch

— Nadia Lilith

— Steve Headly

— Robert Holtsbaum

— Jeff Breland

— One adviser and one legal adviser in relation to insurance to be confirmed.

11. The position paper will then be circulated for further comment within Defence and industry. Feedback from stakeholders will then be reviewed by the joint working group and a final position paper will be drafted. The final position paper will then be submitted for approval within Defence for action by the Procurement Policy Owners being Special Counsel to CEO and Director-General Procurement and Contracting Branch (DGPCB).

Context

12. Any limitation of liability policy will be developed within the parameters of existing Commonwealth and Defence legislative and policy requirements governing risk and liability in Commonwealth procurement. Annex A outlines this legislative and policy framework.
13. Potential benefits of developing an updated liability policy include:
- better risk management processes;
 - reduced time for negotiation of procurement contracts;
 - greater certainty for both parties as to risk sharing with a potential to thereby reduce costs of tendering and contracting; and
 - reduction in complexity of disputes concerning liability issues through clearer allocation of liability in procurement contracts. Potential to thereby reduce time and expense taken to resolve disputes.

Description of Defence Procurement Categories

14. Defence procurement is divided into three broad classifications: Simple, Complex and Strategic. A number of factors should be considered when deciding which category a procurement falls into, including:

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- the nature of the requirement;
 - the degree of risk involved;
 - the value of the procurement; and
 - the time period over which the procurement will take place.
15. The indicative characteristics and the skills required of each procurement classification are discussed below.

Simple Procurement

16. Simple procurement is a procurement category where the overall level of risk and complexity is assessed as low after a suitable risk assessment has been conducted.
17. Simple procurement is conducted in an environment where routines, methods and procedures are well established. Simple procurement usually involves the purchase of standard goods and services or 'commercial-off-the-shelf' items where:
- the level of risk is minimal;
 - standard terms and conditions are used, without alteration;
 - the goods and/or services do not require any development to be undertaken prior to acceptance by Defence;
 - integration of the supplies with existing equipment is not normally required, or where required is straight forward and low risk;
 - the method of procurement is Simple, quotations are sought from a single or restricted field of suppliers (ie a staged procurement process, such as a Request for Proposal or Invitation to Register Interest, is not adopted, nor are open tenders necessarily sought);
 - value for money considerations are restricted to price, quality, fitness for purpose and compliance with required timeframes and delivery needs;
 - payment of the contract price will generally only be made following delivery of the supplies and/or services and acceptance;
 - government furnished facilities, equipment, data, information or services are not required to be provided to the supplier; and
 - specialist advice on legal, contractual, financial or technical considerations is not required.
18. Simple procurement may also occur where an order is placed against an existing standing offer in accordance with the pre-agreed terms and conditions of the standing offer and where the only variables are quantity and delivery point.

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19. Minor departure from one or more of the considerations listed above will not necessarily convert an otherwise Simple procurement into a Complex procurement. Where there is a departure from any of these, a risk assessment should be completed and any determination based on it.
20. Annex A notes that liability capping is not appropriate when using the draft conditions of contract template for Simple procurement. Accordingly, a request to cap liability in an otherwise Simple procurement will result in the procurement being at least a Complex procurement. The templates in the ASDEFCON suite of tendering and contracting templates usually associated with Simple procurement are: the General Conditions of Contract for the Supply of Goods and Services (Form SP20) and the *ASDEFCON (Shortform Services)* for low value, low risk engagement of services providers. Limitation of liability clauses should not be inserted into the SP20 template where there has been a request to cap liability in an otherwise Simple procurement, because of the requirement for a range of Complex procurement activities.

Note: The *ASDEFCON (Shortform Goods)* template has been developed for use in situations where a procurement would be a Simple Procurement but for the need to limit liability. Its accompanying Handbook provides further details on the Complex procurement activities that are required when using this template.

Complex Procurement

21. Complex procurement is a procurement category where the overall level of risk and complexity is assessed as medium to high after a suitable risk assessment has been conducted.
22. Complex procurement is generally carried out under limited guidance within a broad framework of policy and best practice. Complex procurement includes any purchase that is not a Simple or Strategic procurement and usually involves the purchase of more complex goods and/or services where:
 - there is more than a minimal level of risk involved;
 - the monetary value of the purchase is high; or
 - broader value for money considerations apply, including whole of life costing, supplier support capabilities, fitness for purpose and supplier past performance.
23. In addition, the following circumstances may apply:
 - some non-standard terms may need to be negotiated;
 - more complex payment mechanisms may be adopted (eg advance or progress payments);

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- the method of procurement may be more complex (ie a staged procurement, such as a Request for Proposal or Invitation to Register Interest approach may be adopted);
 - detailed evaluation criteria may need to be developed;
 - integration of the supplies with existing equipment may be required;
 - government furnished facilities, equipment, data, information or services may be required to be provided to the supplier; and
 - specialist advice on legal, contractual, financial or technical considerations may be required.
24. Annex A details the standard approach to capping liability in the template draft conditions of contract for Complex procurement. The templates in the ASDEFCON suite usually associated with Complex procurement are: *ASDEFCON (Complex Material) Volumes 1 and 2*, *ASDEFCON (Services)*, *ASDEFCON (Standing Offer for Services)*, *ASDEFCON (Standing Offer for Goods)*, *ASDEFCON (Invitation to Register)*, *ASDEFCON (Request for Proposal)* and *ASDEFCON (Shortform Goods)*.

Strategic Procurement

25. Strategic procurement is a procurement category where the overall level of risk and complexity is assessed as high to extreme after a suitable risk assessment has been conducted.
26. A Strategic procurement usually:
- is critical to Defence's ability to meet its core objectives;
 - is linked to corporate level capability planning decisions;
 - requires the development of a business case; and
 - is likely to be directed by a Government policy decision.
27. Strategic procurement involves the purchase of goods and/or services where:
- there is a high level of risk involved, particularly in terms of program failure and/or cost and schedule overruns;
 - complex value for money considerations apply; and
 - innovative contracting approaches may be required.
28. Specialist advice on legal, contractual, financial or technical matters is required during each stage of a Strategic procurement.
29. Value for money considerations for Strategic procurement would include:

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- criticality to Government business;
 - risks;
 - whole of life costing;
 - fitness for purpose;
 - industry development;
 - supplier support capabilities; and
 - supplier past performance.
30. Annex A details the standard approach to capping liability in the template draft conditions of contract for Strategic procurement. The templates in the ASDEFCON suite usually associated with Strategic procurement are: *ASDEFCON (Strategic Materiel)* and *ASDEFCON (Support)*. (Noting that *ASDEFCON (Support)* is also tailorable for use in Complex procurements).

Risk Management

31. The Commonwealth Procurement Guidelines (CPGs) advise agencies to build risk management into their procurement processes. Paragraph 6.8 states:
- The extent of risk management required will vary from following routine procurement processes to a significant undertaking involving the highest level of planning, analysis and documentation.*
32. However, the Defence procurement being considered for the purposes of this paper is procurement associated with the acquisition, sustainment and disposal of Defence capabilities. Risk assessment in this context occurs at a program or project level for the capability and is then refined by procurement. Procurement for a particular strategic capability may be a mix of Strategic (eg the initial development and acquisition of a system), Complex (eg acquisition of support services) and Simple (eg purchase of a range of low value spares) procurement over the life of a capability.
33. Defence policy places particular reliance on the risk assessment process to assist in the identification of a particular procurement as being Simple, Complex or Strategic. Risk assessments are also used to support decisions concerning the contractual liability regime for the procurement including the assessment of value for money in accordance with the CPGs. Although Defence has developed guidance for its personnel in conducting such risk assessments, Defence personnel often lack particular knowledge of relevant suppliers and their supplies that would assist in completing risk assessments. In addition, the guidance does not set out a specific standard risk assessment methodology to be followed in conducting the risk assessment and describing the resulting analysis. Nor is there any consensus between Defence and industry as to how a risk assessment should be conducted. This lack of knowledge and lack of an agreed approach and format can affect the evaluation of offers regarding contractual liability regimes where such offers are not supported by adequate information concerning the supplier's assessment of risk.

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Simple Procurement

Current Approach

34. In Simple procurements liability is determined by common law principles. Risk assessment is conducted to ascertain whether the procurement should be characterised as a Simple procurement or a higher procurement category. More detailed risk assessments are undertaken if a proposal to limit liability is received because the activity can no longer be regarded as a Simple procurement.

Proposed Approach

35. Defence proposes to develop a risk assessment methodology that guides the assessment of risk at a system level rather than for each individual procurement. A risk assessment would be conducted for the system and the risk assessment would be used to identify those products or product categories that are likely to be acquired through Simple procurement. In some cases, the risk assessment would identify that the supplier for an otherwise Simple procurement is likely to insist on a limitation of liability. In that case the procurement could not proceed as a Simple procurement but could utilise the *ASDEFCON (Shortform Goods)* template to specify, on the basis of the risk assessment, a liability regime that would be acceptable to the Commonwealth.

Complex Procurement

Current Approach

36. A risk assessment is undertaken by the Commonwealth to identify the risks to be managed in a Complex procurement as a basis for the clauses to be included in a Request for Tender (RFT). Depending upon the outcome of this risk assessment, a liability clause may not be included in the project's draft conditions of contract. Despite this assessment, some tenderers may propose a limitation of liability approach either as an alternative proposal or as a non-compliant response. Such proposals are not always accompanied by a copy of the tenderer's risk assessment which makes it difficult for the Commonwealth to complete its required risk assessment activities.

Proposed Approach

37. Defence and industry would agree on a risk assessment methodology to be implemented across all Defence procurements going forward. Where the Commonwealth deemed it appropriate, on the basis of the risk assessment, to include limitation of liability clauses in the RFT, tenderers would be invited to submit liability proposals supported by a risk assessment that has been conducted by the tenderer using the agreed methodology. Alternatively, the Commonwealth may not consider it appropriate, on the basis of the risk assessment, to include limitation of liability clauses in the RFT against which tenderers would be asked to indicate compliance. Where tenderers indicated non-compliance or submitted an alternative proposal, tenderers would be required to submit supporting material including a risk assessment that has been conducted by the tenderer using the agreed methodology. In evaluating liability proposals, in the case where tenderers were invited to submit

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such proposals, or in evaluating non-compliant or alternative liability proposals, the Commonwealth would use the tenderer's risk assessment to inform the Commonwealth's current procurement risk assessment and to assess the risk to the Commonwealth of the proposal. Failure by a tenderer to submit a risk assessment in accordance with the agreed methodology in support of a non-compliant or alternative proposal could result in the non-compliant or alternative proposal being excluded from further evaluation. In order to support tenderers' risk assessments in either of these circumstances, tenderers may be required to provide Defence with access to the information and material that has informed their risk assessments.

Strategic Procurement

Current Approach

38. For Strategic procurements Defence undertakes a risk assessment process to identify the risks that must be managed through the procurement process and to identify the potential scope for the Commonwealth to incur liability during performance of the proposed contract. This risk assessment is used to propose the liability approach that would be acceptable to the Commonwealth in the context of the knowledge of the solution being sought. In the majority of cases tenderers are requested to submit their risk assessments as part of their tender responses and in support of any alternative proposal regarding liability. These risk assessments are required to understand any liability regime being offered by the tenderer as an alternative to the Commonwealth's offer on liability in the RFT.

Proposed Approach

39. Given the usefulness to the Commonwealth of having the tenderer's own risk assessment when assessing tenderer's proposed liability regimes, it is proposed that Defence and industry agree a common methodology for undertaking risk assessments for Strategic procurements. The tenderer's risk assessment using this agreed common methodology would be a tender deliverable requirement, notably if the tenderer is non-compliant with the Commonwealth's proposed liability regime or the tenderer is offering an alternative liability proposal. The Commonwealth could then use the tendered risk assessment to supplement its risk assessment and support the evaluation of the proposed liability regime. Clarification of, and agreement on, a combined risk assessment could also occur where tendered risk assessments differ dramatically from the Commonwealth's risk assessment. Information regarding the relative risks of proposals could become a discriminator in selecting the preferred tenderer during negotiations.

Risk assessment methodology

40. Defence is in the process of producing a risk assessment methodology to be used for all procurements. It is proposed that this risk assessment methodology will form the basis for the production of a risk assessment methodology to be agreed between Defence and industry. It is intended that such agreement will be reached through the joint working group between Defence and AIG. The risk assessment methodology is intended to be based on *AS/NZS 4360:2004 Risk Management*.

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Principles for discussion of possible contractual regimes that alter the common law allocation of liability

41. A number of possible principles to clarify the potential liability regime approach are detailed below. The principles refer to the allocation of liability between contractual parties, rather than the allocation of risk. The word 'risk' is used in the paper to mean the possibility of an event occurring. The word 'liability' is used to indicate the obligation to pay for, or to pay to rectify, the consequences of the event when it occurs. In addition, 'must' is used to indicate principles which are to be complied with in all circumstances, whereas 'should' is used to denote principles that represent best practice. It is intended that, before departing from best practice during a particular procurement process, the approval of the Special Counsel to CEO DMO must be obtained.

Note: Comments on the Discussion Paper have queried whether the principles should separate risks associated with defects in supplies from general hazards associated with the performance of the contract. For example, liability for personal injury or death can arise both from defects in supplies and from hazards such as a premises fire whilst the contractor is performing the contract. The insurance situation is different according to the type of risk. More consideration will be given to this approach in the working group discussions.

Principle 1

42. The allocation of liability between the parties to a contract must comply with applicable Commonwealth legislation and policy.

Principle 1A

43. It is acknowledged that there are a number of commercial factors to be taken into account by industry when considering the terms on which goods and services will be supplied.

Principle 2

44. The allocation of liability between the parties to a contract must comply with the principle that risks should be borne by the party best placed to manage them, i.e. prevent or lessen the possibility of the event occurring or mitigate the consequences should it occur.

Principle 3

45. The Commonwealth must not consider a proposal from industry to limit liability without first reviewing a comprehensive risk assessment. It is proposed that Defence and industry agree a common methodology for risk assessments to allow tenderers to submit standard risk assessments with any proposal to limit liability.

Principle 4

46. Subject to Principle 8, each party must manage the risk of and take responsibility for injury to or death of its employees.

Principle 5

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47. The Commonwealth should not agree to a limitation on the contractor's liability to the Commonwealth for claims by third parties in respect of personal injury and death that arise as a consequence of an unlawful or negligent act or omission or breach of contract by the contractor, its officers, employees, agents or subcontractors.

Principle 6

48. The Commonwealth should not agree to a limitation on the contractor's liability to the Commonwealth for claims by third parties in respect of property damage that arise as a consequence of an unlawful or negligent act or omission or breach of contract by the contractor, its officers, employees, agents or subcontractors.

Principle 7

49. The Commonwealth should not agree to a limitation on the contractor's liability to the Commonwealth for claims by third parties in respect of:
- intellectual property infringement, where the intellectual property in question was supplied to the Commonwealth by the contractor and the Commonwealth is not in breach of the conditions of that supply;
 - breach of confidentiality, where the claim arises as a result of the contractor's conduct; or
 - breach of privacy obligations, where the claim arises as a result of the contractor's conduct.

Principle 8

50. Each party must manage the risk of and take responsibility for its unlawful or negligent acts or omissions and those of its officers, employees, agents or subcontractors.

Principle 9

51. The contractor should manage the risk of and take responsibility for loss of, or damage to, supplies at any time that the supplies are in the contractor's care, custody or control except where loss or damage results from the impact of war, terrorism, insurrection, ionising radiation or radioactivity, government confiscation or nationalisation.

Principle 10

52. Provided the contractor takes appropriate steps to care for, preserve and protect Commonwealth property (excluding supplies provided by the contractor under the contract) in its care, custody, or control, the Commonwealth and the contractor may agree to limit the contractor's liability for loss of, or damage to, Commonwealth property (whether or not in the contractor's care, custody or control) on a basis that represents overall value for money to the Commonwealth. Any such agreed limitation may distinguish between Commonwealth property administered within the Defence portfolio and other Commonwealth property where there is a risk of loss of or damage to other Commonwealth property as a result of contractor activities.

Principle 11

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53. If an exclusion of liability is included in the contract it must be stated in clear terms and set out specific types of loss or damage to be excluded. Generic descriptions such as “all consequential loss” must not be included. Any agreed exclusion must not limit the contractor's liability to the Commonwealth in respect of third party claims, including third party claims for pure economic loss.

Principle 11A

54. The Commonwealth must not agree to generic contractual statements that its remedies will be limited to those expressed in the contract. The Commonwealth may agree to limit its remedy for a specific type of loss or damage to a particular contractual remedy where such a limit represents overall value for money to the Commonwealth. For example, if liquidated damages are specified in the contract for a particular period of delay, the Commonwealth generally agrees to the liquidated damages being the sole remedy for the delay.

Principle 12

55. Provided appropriate warranty and latent defect provisions are in place in the contract to remedy a particular defect in supplies, and provided that the contractor's liability in respect of third party claims is not affected, the Commonwealth and the contractor may agree a financial cap on the contractor's liability to the Commonwealth for damage suffered as a consequence of defects in supplies on a basis that represents overall value for money to the Commonwealth.

Principle 13

56. Where liquidated damages for delay in delivery have been included in the contract, the Commonwealth and the contractor may agree a financial cap on the payment of such liquidated damages provided that:

- there is a right for the Commonwealth to terminate the contract for default should the cap be reached; and
- either the cap is sufficient to appropriately compensate the Commonwealth for its loss in the event of termination or there is a right to claim damages at common law on termination.

Principle 14

57. Consideration of a liability regime based on the above principles should also take into account the availability of insurance in the industry sector being contracted recognising that:

- some insurance is not available or relevant to certain industry sectors; and
- some specific insurances should be considered mandatory for contracting in certain industry sectors e.g. hangar-keepers' liability insurance.

Principle 15

58. The liability of a contractor must not be limited in respect of the fraud or dishonesty of the contractor, its officers, employees, agents, or subcontractors.

Principle 16

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59. If the Commonwealth is required to provide a warranty or indemnity (for example a warranty in respect of Commonwealth mandated Government Furnished Material) the Commonwealth may seek a financial cap on its contingent liability under the warranty or indemnity.

Principle 17

60. The Commonwealth and the contractor may agree to an overarching aggregate financial cap on those areas of the contractor's liability that have been limited in accordance with these principles, provided that the value of the aggregate financial cap is sufficient, taking into account the effect of the Commonwealth's potential exposure to liability, in excess of the aggregate cap, on the transaction's overall value for money to the Commonwealth.

Clarification of principles

61. For the avoidance of doubt clarification of the meaning of several of the principles is set out below.

Allocation of liability - Principle 2

62. In applying Principle 2 it is recognised that the overarching principle is that "risks be borne by the party best able to manage them." Allocation of liability is not the only way of managing risk in this context. For example, risk can also be managed through insurance, as addressed in Principle 14, which may impact on which party is best able to manage relevant risks and how liability should be allocated. It is also possible that some risks are not capable of being managed economically. The practical reality of the circumstances of the parties in relation to the management of risk needs to be considered in each instance.
63. There is some degree of tension between Principle 2 and the concept of an assessment of "overall value for money to the Commonwealth" in Principles 10, 11A, 12 and 17. The principle that "risks be borne by the party best able to manage them" should be taken into consideration in terms of the assessment of "overall value for money to the Commonwealth" and where there is conflict between the two principles, the former principle should take precedence.

Risk assessment - Principle 3

64. It is intended that the risk assessment to be conducted by the Commonwealth in accordance with Principle 16 be based on the agreed risk assessment methodology discussed in paragraph 40 of this Discussion Paper. It is intended that this risk assessment methodology will set out the way in which a risk assessment process should be taken into account in a tender evaluation process and at other times during the life of a project.

Damage to supplies - Principle 9

65. The intention of Principle 9 is for the contractor to bear the risk of loss of or damage to supplies when those supplies are in the contractor's care, custody or control. This circumstance is distinct from a failure by the contractor to perform the contract. In other words, it is not intended that Principle 9 apply to a circumstance where a supply has been delivered to the Commonwealth and it is found that the supplies do not comply with the contracted requirements. This could be discovered:

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- by way of acceptance testing, which is a mechanism to mitigate the risk of a failure to perform the contract, in which case the Commonwealth may reject the supplies; or
- after acceptance, in which case the Commonwealth would be able to rely on any warranty and latent defect provisions that are in place in the contract.

66. Principle 9 does not apply to loss or damage to supplies when those supplies are in the Commonwealth's care, custody or control. In so far as such loss or damage has been caused by a supply not complying with the contracted requirements then the liability of the contractor for such loss or damage could be subject to any limitation of liability, such that the contractor would only be responsible for that loss or damage up to the level of the limitation.

Overall value for money - Principles 10, 11A, 12 and 17

67. The CPGs provide that value for money is the essential test against which any agency must justify any procurement outcome. The assessment of value for money should not be based on price alone. In the context of Principles 10, 11A, 12 and 17 the assessment of overall value for money requires an overall analysis of all relevant costs and benefits associated with the proposed limitation of liability, limit of remedy, financial cap on the contractor's liability to the Commonwealth for damage suffered as a consequence of defects in supplies or overarching aggregate financial cap respectively. In addition to an assessment of financial considerations this requires an assessment of risk.

Direct and consequential loss - Principle 11

68. The term "consequential loss" as referred in the context of Principle 11 has no settled meaning in Australian law. Generally however, such losses usually take the form of economic loss such as loss of profits or revenue or loss of earnings. This contrasts with what is traditionally considered to be direct loss which is a loss that would usually take the form of any loss that is a direct result of a party's act or omission.

69. Commonwealth policy is that liability should be assessed on common law principles, i.e. follows the event and therefore includes consequential damage/loss where such is assessed.

70. Rather than relying on general terms such as "consequential loss", which do not have any settled meaning, it is important that any exclusion of liability included in a contract be clearly described and set out specific categories of loss or damage to be excluded in order to achieve clarity in relation to the allocation of liability.

Capping contractor's liability for the consequences of defects - Principle 12

71. For the avoidance of doubt the intention behind Principle 12 is to provide a financial cap on the contractor's liability to the Commonwealth for the "consequences" of defects, in other words damage caused by such defects, rather than a financial cap on the contractor's liability to repair or replace defective supplies.

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72. In terms of liability to repair or replace defective supplies, this would normally be covered by the appropriate warranty and latent defect provisions referred to in Principle 12.

Insurance - Principle 14

Note: A number of comments on this Discussion Paper concerned the need for further guidance and analysis in relation to insurance. It is intended that a review be undertaken to see what recommendations for further guidance may be needed.

Fraud or dishonesty - Principle 15

73. Principle 15 provides that the liability of a contractor will not be limited in respect of the contractor's or its officers, employees, agents, or subcontractors fraud or dishonesty. It is recognised that fraud or dishonesty connotes an element of intent or recklessness beyond mere inadvertence. It is not intended that this principle apply to negligent acts or omissions.

Implementation of the potential liability regime approach

74. Staffing and resourcing

Note: Comments on this Discussion Paper raised a number of concerns in relation to staffing and resourcing limitations in implementing the potential liability regime approach. Consideration will be given as to recommendations to be included in this Discussion Paper regarding this issue.

75. It is intended that implementation of the potential liability regime approach not be onerous.

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Limiting Suppliers' Liability - the Policy Framework

76. This Annex sets out the legislation, and summarises Australian Government and Defence policy, relevant to limiting suppliers' liability in procurement.

LEGISLATION EXTRACTS

Financial Management and Accountability Act 1997

S.44 Promoting efficient, effective and ethical use of Commonwealth resources

- (1) A Chief Executive must manage the affairs of the Agency in a way that promotes proper use of the Commonwealth resources for which the Chief Executive is responsible.
- (2) If compliance with the requirements of the regulations, Finance Minister's Orders, Special Instructions or any other law would hinder or prevent the proper use of those resources, the Chief Executive must manage so as to promote proper use of those resources to the greatest extent practicable while complying with those requirements.

- (3) In this section:

proper use means efficient, effective and ethical use.

Financial Management and Accountability Regulations 1997

R.7 Commonwealth Procurement Guidelines

- (1) The Finance Minister may issue guidelines (to be called ***Commonwealth Procurement Guidelines***) about matters relating to the procurement of property and services, including:
 - (a) matters affecting Commonwealth contracts or agency agreements; and
 - (b) the publication of details of Commonwealth contracts and agency agreements; and
 - (c) the disposal of public property.
- (2) Commonwealth Procurement Guidelines must not be inconsistent with:
 - (a) the Act; or
 - (b) these regulations; or
 - (c) FMA Orders.

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- (3) Commonwealth Procurement Guidelines may require that a matter must be published in the way set out in the Guidelines.

R.8 Officials to have regard to guidelines

- (1) An official performing duties in relation to the procurement of property or services must have regard to the Commonwealth Procurement Guidelines.
- (2) An official who takes action that is not consistent with the Guidelines must make a written record of his or her reasons for doing so.

R.9 Approval of spending proposals — principles

- (1) An approver must not approve a proposal to spend public money (including a notional payment within the meaning of section 6 of the Act) unless the approver is satisfied, after making such inquiries as are reasonable, that the proposed expenditure:
 - (a) is in accordance with the policies of the Commonwealth; and
 - (b) will make efficient and effective use of the public money; and
 - (c) if the proposal is one to spend special public money, is consistent with the terms under which the money is held by the Commonwealth.
- (2) Subregulation (1) does not apply to a proposal by an intelligence or security agency, or a prescribed law enforcement agency, to spend operational money within the meaning of section 5 of the Act as modified in accordance with Schedule 2.

R.10 Approval of future spending proposals

If any of the expenditure under a spending proposal is expenditure for which an appropriation of money is not authorised by the provisions of an existing law or a proposed law that is before the Parliament, an approver must not approve the proposal unless the Finance Minister has given written authorisation for the approval.

R.11 Approval of spending proposals — officials

An official must not approve a proposal to spend public money unless authorised by a Minister or Chief Executive, or by or under an Act, to approve the proposal.

R.12 Approval to be recorded

If approval of a proposal to spend public money is not given in writing, the approver must record the terms of the approval in a document as soon as practicable after giving the approval.

*Note: **Document** is not limited to paper documents: *Acts Interpretation Act 1901*, s 25.*

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R.13 Entering into contracts etc

A person must not enter into a contract, agreement or arrangement under which public money is, or may become, payable (including a notional payment within the meaning of section 6 of the Act) unless a proposal to spend public money for the proposed contract, agreement or arrangement has been approved under regulation 9 and, if necessary, in accordance with regulation 10.

AUSTRALIAN GOVERNMENT POLICY

77. Defence, including the Defence Materiel Organisation, is required to ensure that a procurement complies with Australian Government policies that interact with the procurement.¹ Those Australian Government policy's which are most relevant are:
- Financial Management Guidance No. 1, *Commonwealth Procurement Guidelines*, December 2008 (CPGs);
 - Finance Circular No. 2003/02, *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort*, September 2003 (FC2003/02);
 - Financial Management Guidance No. 6, *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort*, September 2003 (FMG 6);
 - Finance Circular 2006/03, *Limited Liability in Information Communications and Technology Contracts*, August 2006 (FC 2006/03); and
 - Finance Circular 2007/10, *FMA Regulation 10*, June 2007 (FC 2007/10).

Commonwealth Procurement Guidelines (CPGs)

78. The CPGs are issued by the Minister for Finance and Deregulation (Finance Minister) under regulation 7 of the Financial Management and Accountability (FMA) Regulations.
79. As the name suggests, the CPGs, set out the general policy of the Australian Government in relation to procurements. The CPGs identify value for money as the core principle of Australian Government procurement policy. The CPGs state that an assessment of value for money “requires a comparative analysis of *all* relevant costs and benefits of each proposal throughout the whole procurement cycle”.² This assessment will not only include consideration of price, but will also assess the relative risk of each proposal. It is a requirement of the CPGs that risk management be built into procurement processes.

¹ R. 9, FMA Regulations

² page 16, Financial Management Guidance No 1, *Commonwealth Procurement Guidelines*, December 2008

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80. The CPGs state that an overarching consideration of managing risks in procurement is that risks should be borne by the party best placed to manage them. Agencies should generally not accept risks which another party is better placed to manage. Similarly, where an agency is best placed to manage a particular risk, it should not seek to inappropriately transfer that risk to a supplier.
81. Agencies must undertake a risk assessment to inform any decision about whether limiting a contractor's liability through a liability cap or indemnity would be appropriate, and, if so, what limits may be suitable. For more complex procurements, request documentation should include a draft contract with clear liability provisions. The CPGs require:
- Defence to consider the requirements set out in FC 2003/02 when considering requests for liability caps;
 - Defence to consider the direct and indirect costs of any arrangement to limit liability within the determination of value for money; and
 - Defence to develop and implement a risk management plan if it decides to limit a contractor's liability.
82. Agreements to limit a supplier's liability to the Commonwealth for third party loss are likely to come within the scope of a “contract, agreement or arrangement under which public money ... may become payable” under FMA Regulation 13. The full potential cost to the Commonwealth as a result of these instruments must be considered, and if necessary, authorised under FMA Regulation 10 before the spending proposal can be approved under FMA Regulation 9.
- Finance Circular No. 2003/02, Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort, September 2003 (FC2003/02)***
83. FC 2003/02 states that officials are to follow the policies of the Australian Government promulgated in FMG 6 when considering contingent liabilities that take the form of a liability cap.
- Financial Management Guidance No. 6, Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort, September 2003 (FMG 6)***
84. FMG 6 sets out the Australian Government policy for issuing and managing indemnities, guarantees, warranties and letters of comfort. The policy is not written specifically for capping supplier liability, but the principles in FMG 6 are to be followed when considering such caps. It follows then, that:
- a cap on supplier liability should only be agreed when the risk it is to cover is explicitly identified;
 - a cap should not be accepted where it moves a risk to the Commonwealth that are best managed by the supplier;

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- a cap should not be agreed where it sets an undesirable precedent for future supplies;
 - a request to cap supplier liability is taken into account when assessing value for money;
 - a cap should only be agreed where the expected benefits outweigh the level and costs of the risks, this requires that a comprehensive assessment of the risks is undertaken;
 - if a cap is agreed, appropriate risk management processes are put in place; and
 - all of the legislative obligations on officials are satisfied.
85. In addition there are documentation and disclosure requirements where a cap is agreed. These include comprehensively documenting the decision and maintaining a register of liability caps.

Finance Circular 2006/03, Limited Liability in Information Communications and Technology Contracts, August 2006 (FC 2006/03)

86. FC 2006/03 sets out the Australian Government policy for capping supplier liability in information and communications technology (ICT) contracts.
87. The policy set out in FMG 6 is to be followed when considering capping supplier liability in ICT contracts. However, the default position is that a cap will be applied in ICT contracts, the default position for all other contracts is that a cap will not be applied.
88. In determining the appropriate level for the liability cap for each ICT procurement, a comprehensive risk assessment is to be conducted to:
- determine whether in the particular procurement it is not appropriate to have a cap on liability; and
 - assess the appropriate level for the initial estimate of the cap.
89. FC 2006/03 provides information to agencies about how it is expected that a liability cap will operate. FC 2006/03 stipulates that the following categories of liability should be excluded from a liability cap:
- personal injury including sickness or death - it is preferable that agencies require unlimited liability rather than placing a value (liability cap) on personal injury or death caused by a supplier;
 - unlawful or illegal acts - suppliers should not have their liability limited in relation to unlawful acts or illegal activity;

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- damage to tangible property - standard contract practice includes unlimited liability with respect to property damage and it would be unusual to treat ICT contracts differently;
 - intellectual property obligations - liability for intellectual property infringement in respect of ICT products supplied by a supplier is a fundamental consideration in such contracts as ownership and title of intellectual property rights need to be properly protected;
 - confidentiality and privacy obligations - limiting liability in ICT contracts may interfere with the proper implementation of principles, protocols, practices and legislative obligations with respect to confidentiality and privacy; and
 - security obligations - it would not be prudent to dilute or affect the Australian Government's position with respect to security matters by capping the liability of suppliers in procurement.
90. Whenever an agency is considering capping a supplier's liability for an insurable risk, the agency should contact Comcover to determine whether its own insurance cover is affected. Agencies could prejudice their own insurance cover if they do not do this.

Finance Circular 2007/10, FMA Regulation 10, June 2007 (FC 2007/10)

91. It may be necessary for agencies to seek approval from the Finance Minister in relation to some proposals to spend money. FMA Regulation 10 prohibits the approval of a spending proposal that is not fully supported by an available appropriation (either in an Act or proposed in a Bill before the Parliament), unless the Finance Minister has given written authorisation for the approval.
92. The function of providing authorisation under FMA Regulation 10 has been delegated, *with limits*, from the Finance Minister to all FMA Act agency Chief Executives.
93. In relation to capping supplier liability, a spending proposal that is not fully supported by an available appropriation will arise when:
- a supplier's liability to a third party is limited so that the Commonwealth is liable to the third party for any excess;
 - a supplier's exposure for damage the supplier has suffered itself is limited so that the Commonwealth is liable to the supplier for any excess; or
 - a supplier's liability to meet costs that the Commonwealth may seek to recover from the supplier is limited, where a third party has sued the Commonwealth for damage resulting from the supplier's action or inaction.
94. It can be very difficult and complex for an agency to agree a cap on a supplier's liability that either:

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- also limits third party liability; or
- provides an indemnity from the Commonwealth to the supplier, in favour of the supplier or a third party.

DEFENCE POLICY

95. Defence has developed its own policies relevant to capping supplier liability. These are:
- Chapter 3.2 *Risk Management* and Chapter 3.15 *Insurance and Indemnities* of the *Defence Procurement Policy Manual (DPPM)*; and
 - standard limitation clauses found in some ASDEFCON suite templates.
96. Additionally Defence has developed risk management policies, consistent with international standards such as AS/NZS 4360:2004 *Risk Management*, which are to be adhered to as required by Defence policy. For example the *Project Risk Management Manual*, June 2004. This Annex does not summarise the policies contained in the specific risk management documents.

Defence Procurement Policy Manual (DPPM)

97. The DPPM states that the CPGs and other Australian Government policies apply to Defence procurement. The DPPM builds on Australian Government policy in developing Defence specific policy in relation to capping supplier liability.
98. Defence has a preference for liability under its contracts to be determined according to principles of Australian common law. For a loss to be recoverable under Australian common law the following conditions will usually need to be met:
- a causal connection must exist between the breach or negligent act of the supplier and the loss suffered by Defence;
 - the loss must not be too remote; and
 - Defence must have taken reasonable steps to mitigate its loss.
99. Proposals to limit supplier liability are to be considered on their merits and within the value for money context.
100. It would be extraordinarily unusual for Defence to accept any limitation of a supplier's liability in relation to:
- personal injury or death;
 - third party property damage; or
 - indemnities provided by the supplier under the contract.

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101. Additionally, any other limitation of a supplier's liability for third party claims should be avoided.
102. Where an in-principle agreement is given to a cap on supplier liability, Defence will not automatically accept that it is appropriate to limit liability to either:
 - the value, or a multiple of the value of, the supply; or
 - the insurance covered by the supplier.
103. Prior to agreeing to any limitation of liability a risk assessment must be undertaken to ensure that the liability cap proposed takes into consideration the likelihood and consequences of all relevant risks.

ASDEFCON suite of tendering and contracting templates

104. The ASDEFCON suite templates reflect Defence's standard contracting approach to the inclusion of a cap on supplier liability.
105. The standard clause for *ASDEFCON (Strategic Materiel)* draft conditions of contract:
 - identifies specific categories of liability that may be limited and provides that they can be limited to different levels;
 - excludes, from the cap, liability for:
 - personal injury and death;
 - loss of, or damage to, third party property or Commonwealth property (other than Defence property);
 - breach of intellectual property rights, confidentiality, privacy or security obligations;
 - fraud or dishonesty;
 - unlawful or illegal acts;
 - the intellectual property indemnity provided by the supplier; and
 - the privacy indemnity provided by the supplier.
106. The standard clause for *ASDEFCON (Support)* draft conditions of contract:
 - identifies specific categories of liability that may be limited and provides that they can be limited to different levels;
 - excludes, from the cap, liability for:

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- personal injury and death;
- loss of, or damage to, third party property; or
- the intellectual property indemnity provided by the supplier.

107. The optional clause for *ASDEFCON (Complex Materiel)* Volume 2 draft conditions of contract:

- identifies specific categories of liability that may be limited and provides that they can be limited to different levels;
- excludes, from the cap, liability for:
 - personal injury and death;
 - loss of, or damage to, third party property; or
 - the intellectual property indemnity provided by the supplier.