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Specialists in Strategic, Enterprise and Project Risk Management

Estimating Liability Limits for Supply Contracts

1 Background

Traditionally, Commonwealth and State Government agencies have included provisions in their contract templates that require suppliers to Government to assume unlimited liability. This is generally in accordance with Government policy – the Commonwealth Procurement Guidelines (CPGs) recommend that, in most cases, the limit of supplier liability in procurement contracts is to be unlimited. Clauses 6.12 to 6.19 of the CPGs provide guidance on the Government’s approach to limited liability and under what circumstances something less than unlimited liability may be agreed in a contract.

Recently the Commonwealth Government has implemented a policy that, for the first time, has signalled a move away from the requirement of unlimited liability in contracts where the risks are substantially and demonstrably lower, and where unlimited liability imposes a burden on the supplier, for which they will charge, without generating any real benefit for the Commonwealth. The policy proposes that, in these cases, a more realistic limit of liability may be derived from a risk assessment. Information technology, communications and telecommunications (ICT) contracts are specifically targeted in the policy.

The Department of Finance and Administration issued a Guide on the application of this policy on 16 August 2006. The full guide¹ and its quick-reference companion² are available from the DCITA website at www.DCITA.gov.au.

Broadleaf and law firm Blake Dawson Waldron (BDW) worked with DCITA to prepare the guide and its companion. This work included extensive consultation with Commonwealth agencies, industry and other critical stakeholders such as the Department of Finance and Administration. This work has given us a unique and in-depth view of supplier liability in procurement organisations and agencies.

2 Modelling Liability

Over the past two years Broadleaf has been contracted by a number of agencies to develop, refine and implement an effective model to assist both agencies and industry in estimating appropriate levels of liability to be included in contracts. This model is consistent with emerging government policy on supplier liability in ICT contracts and has proven successful and cost effective.

The model has shown itself to be applicable across a wide range of contracts and to both industry and government clients. The process is a logical extension of more traditional risk assessments. It incorporates simple but effective simulation methods to represent sources of liability and assess liability levels.

¹ http://www.dcita.gov.au/data/assets/pdf_file/41968/ICT_Liability_Guide.pdf

² http://www.dcita.gov.au/data/assets/pdf_file/34329/Companion_to_ICT_Liability_Guide.pdf

3 Legal Context

From a legal perspective, our approach is focused on understanding the scenarios and events where a supplier may be in breach or negligent in its acts under a contract, leading to the client incurring damages or additional costs.

It is reasonable to assume that each contract will contain unique features, so the risk assessment process needs to be tested against the proposed contract and tailored to fit the specific contract requirements. Such specific requirements could include how product and public liability is addressed, how professional liability is dealt with, and how these liabilities interact with the insurance and other contractual provisions such as performance guarantees and liquidated damages.

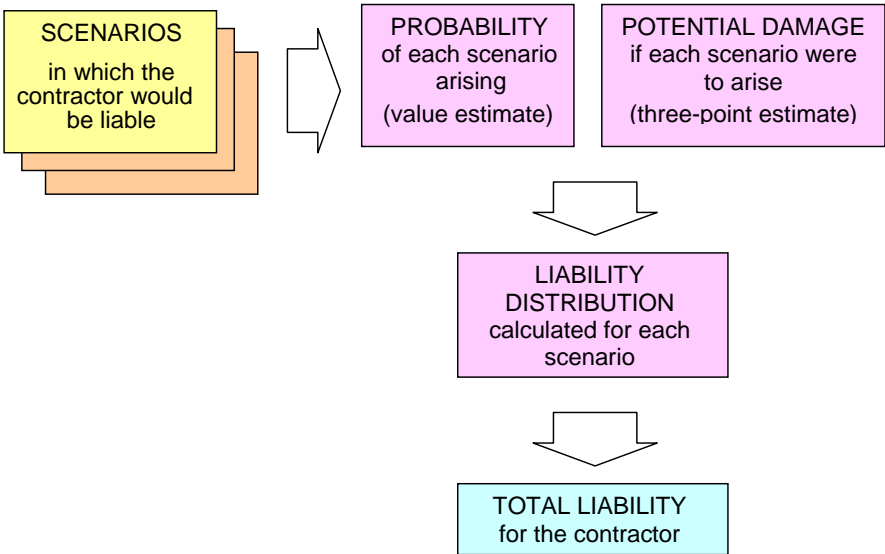
On occasions, common law, legislation or other regulatory frameworks will dictate how liability is dealt with. For example, courts will determine appropriate levels of damages in instances of injury or death, so any proposed limits will not apply to these circumstances. In other instances, limits of liability may not apply to damage to property, infringement of copyright or intellectual property rights, or to the loss of confidential information. The contracts should specify whether these areas are to be left unlimited or capped to some extent.

4 Modelling Process

The process developed and refined by Broadleaf over a number of assignments involves the following steps:

- Conduct an assessment of risks to the procurement activity;
- Identify risks that relate to supplier negligence or omissions;
- Develop quantitative estimates of the likelihood of these risks occurring;
- Develop a quantitative estimate of the best case, most likely and worst case financial impacts of these risks on the customer;
- Describe these risks in a scenario-based Monte carol simulation model and tailor the model to the specific characteristics of the contract;
- Simulate the outcome over many thousands of iterations;
- Summarise and analyse the results; and
- Determine a suitable level of confidence for a limit of supplier liability.

Figure 1: Liability estimating process



The output of the model presents a range of levels of liability the customer might demand, based on the level of confidence the agency requires that the liability cover will not be exceeded during the course of the contract.

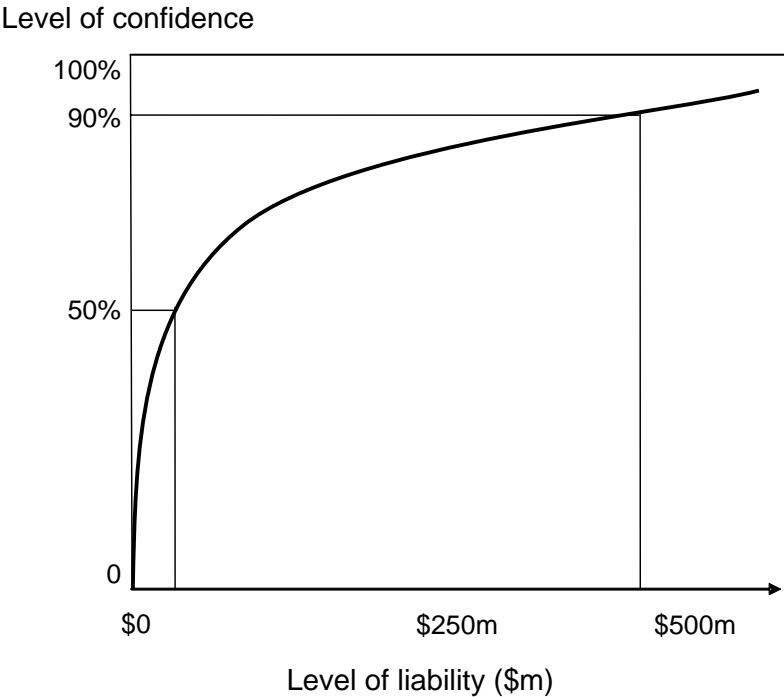
An example output is shown in Table 1 and Figure 2. Constructing an appropriate model and collecting the required data must take into account the level of confidence the agency requires. An understanding of the limitations of the input data and the model is necessary to assess and qualify the output, especially when dealing with the tail end of the probability distribution. The final outcome is a value indicating the level of liability that will not be exceeded during the course of the contract to the required level of confidence.

Table 1: Model tabular output – summary level

Confidence	Liability (\$m)	Confidence	Liability (\$m)
90.00%	55.4	99.50%	71.3
95.00%	59.8	99.90%	77.8
97.50%	63.6	99.95%	81.5
99.00%	68.0	99.99%	99.5

This tabular information can also be depicted graphically, showing the relationship between the level of confidence required by the agency and the limit of liability. This is shown in Figure 2.

Figure 2: Model graphical output (indicative)



5 Benefits

- Advantages that arise from adopting this process for estimating limits of supplier liability include:
- Improved insight into the potential sources of liability;
 - A common understanding between customers and suppliers of the nature and magnitude of potential liabilities;

- Avoidance of costs associated with unnecessarily high limits of liability that deliver no value to the customer; and
- Simpler and faster negotiation of contract terms associated with supplier liability.

Explicit in this process is the need to undertake a risk assessment as the basis for the model. A key requirement and a significant benefit of this process is that agencies and industry alike must systematically identify, assess and manage the risks involved in their procurement activities.

Through this process, agencies and industry members develop estimates of supplier liability that are derived from detailed risk assessments. This is a significant shift from previous practices where the limits have often been set and linked somewhat arbitrarily to insurance levels or contract values. Limits of liability developed using this process reflect our best understanding of the risks to the contract and how they may impact on us financially.

Typically, estimates of supplier liability based on actual risks are lower than limits set as a multiple of contract value or supplier insurance levels. Lower levels of liability translate to lower insurance costs for suppliers and less financial exposure. Suppliers commonly pass the cost of liability and insurance to the agency by including this cost in the contract price. Agency contracts that include liability limits derived through the conduct of risk assessments should cost less than those with unlimited liability.

When supplier liability limits are derived from detailed risk assessments, they are generally more acceptable to all parties than unlimited liability or liability limits calculated as multiples of contract value. This approach should lead to more successful negotiations, with less time and resources spent negotiating liability levels. Often, there is no negotiation necessary as the proposed supplier liability levels are immediately recognised as reasonable.

6 Contacts

If you require more information on modelling contractual liabilities, please contact one of the members of Broadleaf shown below. More information about us and what we do is provided on our web site at www.Broadleaf.com.au.

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