



Stuart van Rij

Capping liability

“SO, WHAT SHOULD the cap on liability be?” This is a common question for all who have been involved in negotiating an IT or telecommunications agreement. Getting to that magical figure can often resemble a shot-from-the-hip instead of something that has been carefully considered and negotiated.

It's not uncommon for a customer to shrug off an analysis of liability on the basis that “if we get to that stage, the relationship's stuffed anyway” or “we're never going to sue”. However, this ignores the significant costs of project failure and the incentive that a sufficiently high cap on liability can have in motivating a supplier to deal with problem projects.

Importantly, the implications of just living with the supplier's standard exclusions and cap on liability can be severe: They frequently leave the customer with remedies that are minuscule in comparison to the actual losses it suffered as a result of the supplier's failure.

While it's generally appropriate for a supplier to limit some of its liability, the challenge is to settle on a figure that fairly reflects and allocates the relevant risks.

An Australian approach

For a medium-risk or high-risk project, you may want to con-

sider using A Guide to Limiting Supplier Liability in ICT Contracts with Australian Government Agencies. The Guide moves well beyond a “gut feel” or back-of-the-envelope approach and is useful for private and public sector purchasers.

The Guide suggests a comprehensive risk assessment process be undertaken. Purchasers often do this type of risk assessment as part of a business case.

It then proposes methods of estimating liability that range from the basic (picking the highest value risk) to the sophisticated (the construction of risk models and use of specialised software).

As well, a helpful checklist of typical ICT contract risks to consider is included. However, it does not advocate a pure “checklist” approach to addressing risk. Instead, the checklist recommends brainstorming in a group workshop as a more effective way to identify the risks and their consequences.

While focusing on limiting supplier liability, the Guide also touches on related liability issues that shouldn't be neglected — such as areas of liability that should usually be uncapped and exclusions of liability for indirect or consequential losses.

Overall, the approach proposed by the Guide goes well beyond

what often happens in practice, even in big deals.

Ten times the contract price?

The Guide contains a case study relating to the development of a complex operational system, costing A\$2.5 million. The agency's risk assessment concluded (with the help of models and simulations) the agency could face financial impacts of up to \$25 million if the stated risks were to occur. So, the cap was set at \$25 million.

This is a far cry from the standard supplier approach of capping liability to the amounts paid under the contract. Most suppliers would balk at the prospect of a cap on their liability being 10 times the contract price.

However, to be fair, the potential losses the customer could incur if the supplier fails to deliver will, in many cases, exceed the amount paid to the supplier. Undertaking proper risk analysis will often reveal whether this is the case. It also provides a more reasoned basis from which to negotiate an appropriate allocation of liability, including any impact on pricing.

Some may think all this risk analysis is overkill in the interests of arriving at a dollar figure. However, for medium-risk and high-risk projects there is significant value in the journey as

well as the destination. While the cap on liability could just end up as the ambulance at the bottom of the cliff, a careful risk assessment is of value in identifying the measures needed to help fend off project failure.

Whatever way you look at it, setting a cap on liability involves an assessment of the relevant risks. If you're embarking on a medium-risk or high-risk project you'll find the Australian guidance assists in setting an appropriate cap on the supplier's liability. ■



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