

CENTRAL PROCUREMENT DIRECTORATE

PROCUREMENT GUIDANCE NOTE 01/06

SUBJECT: OGC GUIDANCE – LIABILITY IN GOVERNMENT CONTRACTS

Liability in Government Contracts

1. Summary

This note provides guidance to Contracting Authorities on the issues that need to be considered in deciding whether, and to what extent, contractor liability should be limited or excluded in Government contracts. It makes clear that limiting or excluding liability is a matter to be considered in each case on its merits. The guidance should not be seen as a major change of direction: it is more a change of emphasis to ensure that the issue of liability is considered in a flexible way, reflecting value for money considerations.

2. Background

The most recent guidance on liability and insurance in Government contracts is included in the commentary on Condition 28 in CUP 59(D). This states that:

"Condition 28 requires the Contractor to indemnify the Authority in respect of personal injury or damage to property claims arising from the Contractor's act or omission unless he can show that he has not been negligent or that the circumstances were outside his control."

It continues:

"...there is no contractual limitation on the amount of the Contractor's liability."

The commentary goes on to state that:

"However, the Authority may consider whether in the particular circumstances of the contract there should be a limit or specified exclusions of liability."

In practice, Departments have, understandably, taken a rather cautious view of what this means, focussing on the "requirement" for unlimited liability rather than the scope to limit liability in "particular circumstances". This has meant that there has been a tendency to insist on unlimited liability in all circumstances, regardless of the facts of the case. This is likely, in many cases, to have had an adverse impact on competition and value for money where, for example, suppliers have refused to take part or where tender prices have been increased to compensate for the insurance costs of meeting unlimited liability. Feedback from Departments indicates that, in many cases, these have been real matters of concern. Further, the guidance on Condition 28 strictly relates only to the scope of the indemnity contained in that condition and not to wider issues of the Contractor's potential liability under the contract, particularly claims by the Authority for other financial loss occasioned by the Contractor's default.

In the light of the uncertainty about the scope for limiting liability, and the difficulties which have resulted from this apparent inflexibility, which a number of Departments have brought to our attention, we believe that it is necessary to provide new guidance on a more comprehensive basis. In drafting the guidance, our starting point has been that liability should be considered on a case-by-case basis, reflecting value for money considerations. Our aim has been to provide a steer on the issues which need to be addressed in considering whether a limit, or exclusion, would be appropriate and on how limits or caps should be set.

3. Approach to liability

Decisions on liability remain the responsibility of the individual Contracting Authority, in the light of the specific circumstances. However, in considering liability, the Authority should take account of the following issues.

4. Death and Personal Injury

Liability should remain unlimited in areas where legislation (the Unfair Contract Terms Act 1977) proscribes limitation. These areas are liability for death and personal injury and for breach of the obligation to possess good title to goods that are sold or hired.

5. Direct Loss or Damage

There is no precise definition for direct loss or damage. The usual definition is that a direct loss is a loss which arises naturally and directly from the breach of contract or negligence. Losses will be treated by the courts as direct losses if they were reasonably foreseeable by the parties as being a likely consequence of a breach at the time that the contract was entered into.

In many cases, it will be possible and sensible to continue to insist on unlimited liability for direct loss or damage. In other cases, it will be apparent from market soundings, or in discussions, that it will not be possible or sensible to insist on unlimited liability, and that value for money considerations point to some limit or cap. This might be because competition will be too restricted by an insistence on unlimited liability, where companies cannot, or will not, insure to cover such liability. This is likely to be a particular problem for SMEs. Alternatively, or in addition, it might reflect the extra cost to the Department of such a requirement, resulting from bidders including the cost of the (perhaps, unnecessary) insurance cover in their bids. Experience suggests that pressure to limit liability will be greatest in sectors such as IT, management consultancy, professional advice and construction. But there should be no presumption that this will be the case or that other sectors are unaffected.

For some contracts, eg in the IT area, it might be appropriate to have separate limits for different kinds of losses – damage to property (where the limit might relate to the property value), other pre-acceptance losses (including claims under IPR indemnities) and other post-acceptance losses.

Another issue is whether there should be a limit of liability relating to each "occurrence". However, this approach can introduce uncertainties into the limitation provision. Where there has been a catastrophic IT system development, for example, it is often difficult to pinpoint the exact cause of the problems and so to determine whether there should be a single or multiple application of the limitation provision. For that reason, it may be preferable to include a provision that specifies the total aggregate liability of the contractor. This means that there is a "pool" of damages available to the customer and once this pool has been exhausted no further damages will be available.

The limit or cap, itself, may be expressed as a sum of money or a percentage of the charges payable under the contract. However, particular care should be taken over using the contract price to determine the appropriate limit. Such an approach is attractive to the supplier because it will naturally prefer to avoid a situation in which the contract results in a net outflow of revenue. It is not, however, a good basis for limiting liability from the customer's point of view, since the contract price may be smaller than the loss that may arise if the supplier is in breach of contract. It is generally preferable for the customer to consider what limitation of liability it can comfortably accept without reference to the contract price. However, it may be advantageous thereafter to express that limitation of liability independently arrived at, as a percentage of the contract price. This will provide for an automatic increase in the limit of liability where the later operation of a change control mechanism in the contract results in a price increase.

The limit should not be so high that the commercial risk for the contractor becomes unacceptable. The aim should be to establish liability ceilings reflecting a combination of the best estimate by the Authority of the losses that might be suffered by the Authority (and any other relevant, associated bodies) in the event of a default by the contractor, the likelihood of those losses occurring and the value for money considerations in limiting liability. For estimating property losses, one approach is to make an assessment of costs associated with rebuilding, refurbishing and re-equipping premises in the event of destruction caused by contractor default, taking account of the potential risk. For non-property areas, estimating losses is often difficult. One approach is to assess the approximate costs of recovering from a "worst case" loss of service, based on the impact on the Authority and other users of the services.

6. Indirect and Consequential Loss, Loss of Profits etc

For indirect loss or damage, consequential loss or damage or loss of profits, business, revenue, goodwill or anticipated savings, there is a stronger case for accepting a limitation or exclusion from liability, especially in contracts relating to more sophisticated procurement. However, it is important not to look at these kinds of losses in isolation. There may be a case for seeking to resist the total exclusion of claims for indirect or consequential loss etc where a general cap on liability has been conceded. Again, it is important to consider each case on its merits, in line with value for money considerations.

There should be no exclusion from liability for any additional operational and administrative costs and expenses, or expenditure rendered unnecessary, resulting from the direct default of the contractor.

7. When to consider liability issues

Purchasers should consider these issues as early as possible in the procurement process – eg, when sourcing the market – and decide on any exclusion or cap before issuing the invitation to tender.

8. Model Clause

Attached at annex A is the most recent guidance on liability and insurance associated with Condition 28, which reflects the principles outlined above. We should stress that the clause, itself, is a "model". It is for the Contracting Authority to consider, with its legal advisers, how the clause needs to be adapted in the particular circumstances of the procurement.

9. Insurance – General

The levels of insurance cover should normally be a matter for the contractor, reflecting its estimate of the risks involved. However, the Authority may require, in the contract conditions, that the contractor should effect and maintain a policy or policies of insurance providing an adequate level of cover in respect of all risks which may be incurred by the contractor, arising out of the contractor's performance or purported performance of the contract.

10. Insurance – Employers' Liability Compulsory Insurance (ELCI)

It is a legal obligation on employers to insure against the costs of providing compensation for those employees who are injured or made ill at work through the fault of the employer. The sum insured must be at least £10 million. The client should ask to see a copy of the EL insurance policy and a copy of the certificate of insurance that the employer is required to display in the workplace under the Employer's Liability (Defective Equipment and Compulsory Insurance) (Northern Ireland) Order 1972.

11. Risk Management

It is important to look at contractor liability as part of a general consideration of risk management and risk sharing. At one extreme, it might be that pressure from potential contractors for low limits of liability indicate an unacceptably risky project which should be reconsidered or restructured. In any event, it is vital that, at all stages of a project, proper risk management systems are in place and that all approaches to risk sharing, other than limiting liability, are fully considered.

12. Parliamentary (or Assembly) approval

Caps are not usually reportable, unless the contingent liability or contingent loss is significant (in £s) or of an unusual nature. Please see Annex 26.2 of Government Accounting Northern Ireland.

13. Checklist

The main messages from this guidance are:

- decisions on limiting contractor liability should be taken by Contracting Authorities on a case-by-case basis, reflecting value for money considerations;
- liability should remain unlimited for death and personal injury;
- for many contracts, it may be possible and sensible to also insist on unlimited liability for direct loss or damage;
- however, in other cases, value for money considerations will mean that limits will be appropriate;
- limits or caps should, preferably, be expressed as a sum of money rather than as a percentage of the contract value, reflecting a combination of the best estimate by the Contracting Authority of the losses that might be suffered by the Authority, the likelihood of those losses occurring and the value for money considerations in limiting liability;
- where appropriate, consideration may be given to excluding indirect and consequential losses altogether. However, there may be a case for resisting such exclusions where a general cap on liability has been agreed;
- liability issues should be addressed as soon as possible in the procurement process; and
- insurance cover is a matter for the contractor, although a requirement on the contractor to maintain a policy of insurance at an appropriate level might be considered necessary in some cases.
- The contractor must hold insurance of at least £10 million for the purposes of Employers' Liability Compulsory Insurance (ELCI)

- Contracting Authorities should ask to see the evidence (the policy and the certificate) of Employers' Liability Compulsory Insurance (ELCI).

Annex A

28. INDEMNITY AND INSURANCE

28.1 The Contractor shall indemnify the Authority fully against all claims, proceedings, actions, damages, legal costs, expenses and any other liabilities in respect of any death or personal injury or loss of or damage to property which is caused directly or indirectly by any act or omission of the Contractor. This Condition 28.1 shall not apply to the extent that the Contractor is able to demonstrate that such death or personal injury, or loss or damage, was not caused or contributed to by his negligence or default, or the negligence or default of his Staff or sub-contractors, or by any circumstances within his or their control.

Condition 28 requires the Contractor to indemnify the Authority in respect of personal injury or damage to property claims arising from the Contractor's act or omission unless he can show that he has not been negligent or that the circumstances were outside his control. It requires the Contractor to be insured against all risks of death, personal injury, loss and damage arising from his performance of the contract.

It should be noted that this written indemnity does not define the limits of the Contractor's potential liability to the Authority, which in particular encompass claims for financial loss caused directly or indirectly by the Contractor's default. Because such claims are not expressly excluded or limited by the drafting of Condition 28 or any other condition in these Model Conditions, they are in principle claimable to the full extent allowed by law.

However, the Authority should consider whether, in the particular circumstances of the contract, there should be a limit or specified exclusions of liability. Such consideration may extend both to the areas in which Condition 28 requires the Contractor to indemnify the Authority and to any other areas of potential liability of the Contractor (subject to a statutory

requirement that liability must remain unlimited for cases of death and personal injury and for breach of the obligation to possess good title to goods sold or hired).

Further guidance on the approach to be taken in relation to these questions is contained in a note entitled "Liability in Government Contracts" prepared by the Procurement Policy Unit at the Office of Government Commerce.

28.2 The Contractor shall effect and maintain with a reputable insurance company a policy or policies of insurance providing an adequate level of cover in respect of all risks which may be incurred by the Contractor, arising out of the Contractor's performance of the Contract, in respect of death or personal injury, or loss of or damage to property. Such policies shall include cover in respect of any financial loss arising from any advice given or omitted to be given by the Contractor.

Where the value of any property used by the Contractor, including land, buildings or equipment, is significant, the Authority may wish to give an indication of its value in the Specification for the purpose of insurance under Condition 28.2.

The last sentence of Condition 28.2 may be omitted where the Contractor will not be required to provide advice or any similar professional opinion.

28.3 The Contractor shall hold employer's liability insurance in respect of Staff in accordance with any legal requirement for the time being in force.

28.4 The Contractor shall produce to the Authority's Representative, on request, copies of all insurance policies referred to in this Condition or other evidence confirming the existence and extent of the cover given by those policies, together with receipts or other evidence of payment of the latest premiums due under those policies.

28.5 The terms of any insurance or the amount of cover shall not relieve the Contractor of any liabilities under the Contract. It shall be the responsibility of the Contractor to determine the amount of insurance cover that will be adequate to enable the Contractor to satisfy any liability referred to in Condition 28.2.