COMPUTERS & LAW

Journal for the Australian and New Zealand Societies for Computers and the Law

Editor: Kylie Howard

ISSN 08117225

Number: 65

September 2006

Capping Liability in Federal Government ICT contracts: it has arrived!

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The New Policy

The new ICT Liability Policy (the "Policy") delivers on the Federal Government's election commitment to cap liability for suppliers in ICT contracts. The new Policy applies to all agencies that are subject to the Financial Management and Accountability Act 1997 ("FMA Act") (but not to Commonwealth authorities and companies), who purchase ICT goods and services that are subject to the Federal Government's existing ICT procurement arrangements, known as the Endorsed Supplier Arrangements.

The Policy covers the purchase of IT hardware, software, IT services and major office machines, but excludes the mandatory arrangements for agencies to acquire telecommunications carriage services, (Whole of Government Telecommunications Arrangements).

The Policy requires Federal Government agencies to cap liability at appropriate levels, unless there is a "compelling reason" to require unlimited liability.

This Policy changes the Federal Government's previous default position that all suppliers of ICT goods and services should have uncapped liability. It represents a new era in procurement practices.

As a move forward, the Federal Government has recognised a number of benefits to allowing suppliers to cap their liability including:

- cost savings on the procurement - suppliers that have a lower risk profile can afford to decrease the price of their goods or services;
- saving time, resources and money in negotiations; and
- having access to a fuller range of solutions from suppliers that were previously not interested in entering into an agreement with a risk profile of unlimited liability (particularly the smaller ICT suppliers).

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The Federal Government has also recognised that a cooperative approach to risk sharing can be appropriate, and has provided a guideline that the organisation that is best able to manage the risk should bear that risk.

The Policy Explained in DoCITA's Guide

In August 2006, the Department of Communications, Information Technology and the Arts issued "A guide to limiting supplier liability in ICT contracts with Australian Government Agencies" ("the Guide"), which is intended to assist agencies implement the Policy, and provide guidance to ICT suppliers as to how agencies will implement the Policy.

Which Liabilities are Capped?

The key aspects of the Policy are that in a procurement of ICT goods and services the agency should be prepared to limit the supplier's liability, and determine the amount of the limit based on the outcome of a risk assessment. The Policy states that generally, liability should be capped for losses arising from breach of contract and negligence, but liability that arises from certain categories of liability such as damage to tangible property, personal injury, breach of intellectual property rights, breach of obligations of confidence, privacy or security should remain uncapped, unless there is a compelling reason to do otherwise.

Justifications for not capping certain liabilities.

The Guide provides some interesting insights into the Federal Government's justifications for excluding certain heads of loss from the cap on liability. The reasons put forward are:

1 In respect of liability for breach of intellectual property rights, the justification is that the supplier provides a warranty that it has the right to provide intellectual property rights given under the agreement. That warranty is equivalent to a standard warranty that the supplier of goods has the right to pass title to those goods. It also notes that there is no legal requirement for this liability to remain uncapped.

2 For liability for breach of privacy and confidentiality obligations, the justification is that the public should have confidence that the Federal Government will protect a third party's confidential information and personal information. Additionally, the Federal Government may be under a moral obligation to at least advise persons from whom it obtains confidential or personal information whether it limits the liability of suppliers that have access to that information. It argues that capping liability would interfere with the proper allocation of responsibilities that arise under State and Commonwealth privacy and freedom of information rules and protocols. Again the Guide notes that there is no legal requirement for such liabilities to be uncapped.

3 In relation to liability arising from breach of security obligations (which is a relatively recent addition to the list of 'accepted' exclusions to caps on liability) the justification put forward is that it might dilute the focus of the Federal Government to ensure security is maintained. Again the Guide points out that there is no legal reason (or instruction from the Protective Security Manual) that would prevent liability being capped in this area.

4 For liability that arises from an unlawful, or a wilful act or omission, the justification put forward is simply that it is 'not appropriate' to cap this type of liability.

5 Regarding liability for personal injury, sickness or death, the justification provided is that the Federal Government's preference is not to place a value on personal injury or death', and that these losses may be insurable by the supplier at a reasonable premium.

6 Where damage is to tangible property, the justification provided is that there are 'valid commercial reasons' for not limiting the liability of suppliers, broadly relating to a supplier's ability to insure this type of risk.

The question should be asked as to whether the Federal Government would be comfortable accepting an ICT supplier's reasons for wanting its liability to be capped to lower levels, or for additional heads of loss to be included in the cap, using similar justifications of 'preference', 'moral obligations', appropriateness or 'valid commercial reasons'.

Dealing with Supplier's Contracts, particularly shrinkwrap licenses.

It is clear that the Policy will be implemented in the Federal Government's new model form contracts known as the 'SourceIT model contracts' - we are yet to see the drafting of the relevant clauses. It is also clear that as the Policy applies to all relevant ICT contracts that are issued by all agencies that are subject to the FMA Act and the issue of capping liability must be adopted, and the necessary risk assessment must be conducted, for all procurements, including low risk software products which are sold on the basis of shrinkwrap or clickwrap licences.

Indeed there are practical difficulties in applying such a process when products, usually "off the shelf" type software licences, are supplied via the web (through a click wrap contract) or where terms and conditions are through a shrinkwrap licences. For such products, suppliers are generally reluctant to amend their standard terms and conditions because such licences usually relate to low risk products that are not business critical. Similarly, customers are often reluctant to negotiate amendments to such terms due to the low risk and low cost nature of such products - customers of such products often take the attitude that if the product doesn't work, it can simply be replaced by another product in the market without suffering much loss in the meantime.

The Policy does not provide any exception for these types of purchases, and agency procurement officers will still need to apply the same principles and processes to procurement of these types of products - which of course, does not seem like the most practical approach for all parties involved.

The Risk Assessment

Clearly the critical step in the practical implementation of this Policy is the risk assessment, as the Policy requires that a risk assessment must be conducted prior to determining the cap of liability. The Guide sets out the preferred approach to conducting the risk assessment which is broadly in line with the Australian/New Zealand Risk Management Standard AS/NZ4360:2004.

The Guide provides a step by step approach to establishing an estimated limit of liability at the time the tender is released, based on a preliminary risk assessment, and suggests that suppliers should be required to submit prices based on this limit of liability, with alternative prices for other limits of liability that may be proposed by the supplier. Indeed the Guide states that estimating appropriate liability limits is one of the essential steps in achieving value for money.

The lower the risk the procurement, then the simpler the risk assessment will be. Although the Guide is primarily targeted at low risk procurements, it gives guidance on how to evaluate medium to high risk procurements, and how to determine a limit of liability in those cases as well. The Guide does not state what the 'compelling reasons' might be for using unlimited liability.

How Might it Work in Practice?

In order for this Policy to give the Federal Government the benefits of lower costing ICT goods and services, a broader competitive market, and appropriate risk sharing arrangements, the Policy will need to be widely and rigorously implemented.

This means of course that there needs to be effective communication of the new Policy to the relevant agencies, both at the senior levels and at the sharp end where the procurement policy hits the tender documents. Procurement officers need to have effective training, and be given access to the necessary external expertise to conduct the risk assessments, and negotiate limits of liability with suppliers. Similarly suppliers need to change their approach from the common 'multiple of fees' position to capping liability, to provide caps of liability that can be supported by risk assessments.

Whilst it is true to say that the types of liability that are outside of the cap are broadly consistent with many substantial contracts with non-government organisations the real issue will be "what is the quantum of the cap". This is real concern given that the case studies in the Guide give examples of dollar values of caps, which are derived from their risk assessments, which are significantly greater than dollar values that would be typically found in contracts with non-government organisations for transactions of a similar nature.

The Policy has not dealt with the situation where the risk assessment results in a cap of liability that is too high for suppliers to accept. Indeed in any contract the supplier has to do its own risk assessment, and determine whether the risks that it is being asked to bear are sufficiently rewarded by the profit that the goods or services will bring.

Summary

Let's not underestimate the significance of this change in policy, and the potential impact that it may have for suppliers and agencies alike. Agencies will no longer be saying that uncapped liability is 'policy', and suppliers will need to change their approach on capping liability. The critical issue will be how this policy is implemented, and whether risk assessments will generate proposed caps of liability that are acceptable to the ICT suppliers. At the very least, we have a framework in which to have those discussions.

And finally the Guide is essential reading for everyone involved in ICT procurement, and it provides not only an explanation of risk assessments, but an interesting explanation of the Federal Government's reasoning and positions on the issues.

References

The ICT Liability Policy is contained in Finance Circular 2006/03 "Limited Liability in Information and Communications Technology Contracts", which is included as an appendix to the Guide.

The Guide is available from www.dcita.gov.au

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Protection of domain names - what rights does a licensee have?

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In the recent case of *Hoath v Connect Internet Services Pty Ltd*[1], the NSW Supreme Court dealt with claims arising out of various changes to the ownership and administration of the internet business "Dragon Net" in the period between 2000-2002. The case is useful for its treatment of the following issues: