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ADVANCE ISSUE

INDEMNITIES IN COMMONWEALTH CONTRACTING

Risk is an essential consideration in all commercial transactions. Risk determines whether a transaction is viable, and risk is an indispensable – albeit often overlooked – component of the transaction's total price. In the Commonwealth context, risk management is a key component of the Commonwealth financial framework.[1]

This briefing discusses how risk can be allocated and managed through the use of transactional documents such as contracts and leases, and in particular by a type of contractual clause known as an indemnity. It looks specifically at indemnities given by the Commonwealth (Commonwealth indemnities) and how they are regulated by the financial framework, before considering indemnities given by other parties to the Commonwealth (contractor indemnities) and the associated issue of liability caps.

Indemnities

Terminology

In this briefing, 'risk' is used to mean the chance of something happening that will have an impact on objectives and potential costs. Risk is often specified in terms of events and consequences, and the magnitude of risk is normally determined by the combination of the consequences of an event and the likelihood of that event occurring.[2]

Another term for the consequence of a risk occurring is 'damage',which goes hand in hand with the legal responsibility for the damage, or 'liability'[3]. Legal agreements such as contracts and deeds assign to one or more parties the liability for damage in the event that a specified risk occurs. An indemnity is a particular type of contractual clause that allocates liability between parties, and is normally expressed in the form of one party 'indemnifying' another for a particular class or classes of liability.

This issue

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In this briefing there is an assumption that the Commonwealth is dealing with a provider of goods or services, who will be referred to as the 'contractor'. The contractor could be anyone – it could be a landlord under a lease; a builder under a works contract; an IT provider; or a specialist consultant engaged by the agency to provide, for example, audit, accounting or legal services. It could be an outsourced payroll function provider; a provider of travel services; a director of a Commonwealth authority or company; or a supplier of goods to the Commonwealth. The discussion is equally applicable to all of these scenarios, but the single term 'contractor' is used for convenience.

Sources of liability

Before examining indemnities in more detail, it is worth commenting on the general nature of contractual liability. One of the primary purposes of all legal agreements is to regulate liability (the other, related, purpose is to provide an agreed statement of the nature of the parties' relationship). It is obvious that, when a party enters into a contract, it is entering into a legally binding arrangement under which it can incur legal liability to the other contracting party for breach of that contract.

However, this does not mean that breach of contract is the only means by which a party may become liable, or that the potential scope of liability is limited to the clauses of the contract. For example, the Commonwealth can lease land from another person, and then conduct an activity which is noisy and noxious and has an adverse effect on other tenants. This could be a breach of the lease, for which the Commonwealth would be liable to the landlord. But it could give rise to liability under other causes of action at the same time. It could also be the tort of nuisance or a breach of applicable environmental legislation.

Identifying all possible sources of potential liability is part of risk management generally. It is particularly relevant to indemnities, however, because being aware of the scope of potential liability assists greatly when it comes to actually considering the terms of proposed indemnities and determining whether they extend the Commonwealth's liability beyond that for which it would be liable in any case (such as in negligence).

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What is an indemnity?

At law, an indemnity is a legally binding promise by which one party undertakes to accept the risk of loss or damage another party may suffer. Essentially, it is a promise to 'hold harmless', and these exact words are often used in indemnity provisions, particularly older ones.

The classical form of indemnity is an insurance contract. Under an insurance contract, an insurer agrees to indemnify the policyholder in respect of certain specified losses and liabilities on the occurrence of certain specified events. In this case, the whole contract is one of indemnity.

The context of this briefing is contractual indemnities, which are a specific class of indemnity. A contractual indemnity is typically one provision of a larger commercial arrangement which states that a party agrees to hold harmless another party against the risk of loss or damage that that other party may suffer (including that party's liability to third parties for third party loss resulting from activities under the contract).

Indemnities create contingent liabilities

When a contract is silent as to how liability is allocated between the parties for risks arising because of the contract, each party's liability will be determined at general law on the facts of each event. To provide greater certainty to the parties and/or to shift liability that would have fallen on one party at general law to another party, a liability regime may be agreed and set out in the contract. To achieve this outcome, the regime may impose a contractual obligation to pay money if a specified event occurs (such as an indemnity). This is called a contingent liability (that is, the liability to pay is contingent upon the event occurring).

Anatomy of an indemnity

Invariably, an indemnity can be broken down into four constituent components: 'who', 'what', 'when', and 'how'.

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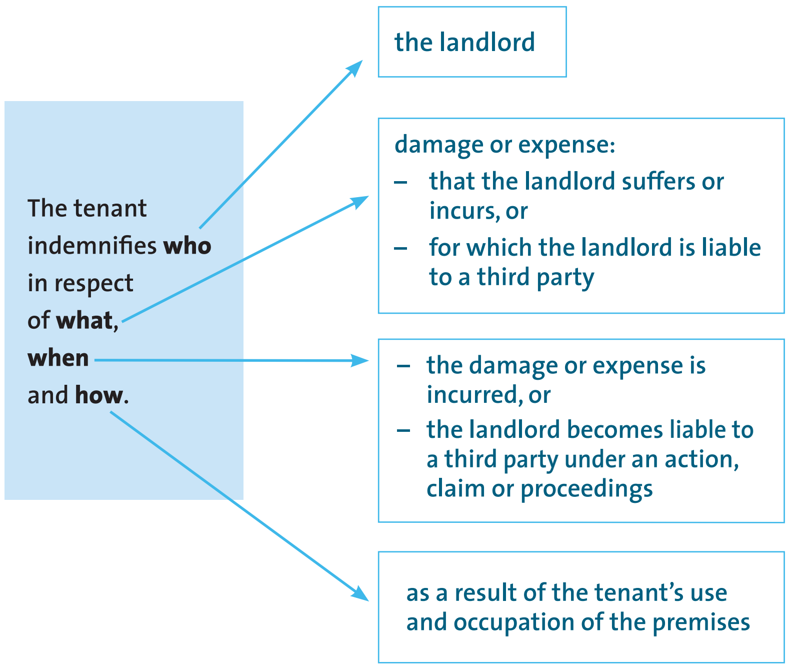
Example

The landlord has requested the grant of an indemnity in the following terms:

> The tenant indemnifies the landlord in respect of all actions, claims, proceedings, losses, costs, expenses and damages which the landlord suffers, incurs or becomes liable for and which arise from the tenant's use and occupation of the premises.



Who gets the benefit of the indemnity?
The first of the four elements is 'who'. This refers to the person that the tenant is indemnifying – in this case, the landlord. In the case of contractual indemnities, the 'who' will almost invariably be the other party to the contract, although sometimes the language used in the contract will be broad enough to extend the 'who' to also include officers, employees, agents, subcontractors, and, in some cases, related parties such as holding companies.

What types of liability does the indemnity cover?
The second element is 'what'. This refers to those things in respect of which the indemnity is granted – in this case, 'all actions, claims, proceedings, losses, costs, expenses and damages'. These are fairly standard terms in an indemnity.

Clearly, there can be a range of different types of liability that might be picked up by this type of language, including liabilities for:

— tangible losses (for example, death and injury, damage to property)

— intangible losses (for example, infringement of intellectual property rights, damage to data, disclosure of personal or confidential information)

— pure economic losses (for example, statutory fines or penalties, lost productivity, loss of opportunity).

When is the indemnity applicable?
The third element is 'when'. In this case, it is those things 'which the landlord suffers, incurs or becomes liable for'. Note that it could have just said those losses, costs and so on 'for which the landlord becomes liable', which is much narrower than losses, costs and so on which the landlord *suffers or incurs*. This is because the use of the term 'liable' implies a legal *obligation* to pay (that is, there is no choice), but, in the case of losses incurred, this is broad enough to encompass voluntary expenditure *incurred* by the landlord in the absence of legal compulsion.

How is the indemnity triggered and what does it cover?
The fourth element is 'how'. It is the most important element of all because it is the trigger that invokes the indemnity. In this case, the trigger is all of those things 'which arise from the tenant's use and occupation of the premises'. This is extremely broad. This indemnity can be activated whether or not there is any fault on the part of the tenant.

The fourth element ... is the most important element of all because it is the trigger that invokes the indemnity.

A much narrower provision would be something like 'arising out of the negligence of the tenant'. This actually requires actionable negligence on the part of the tenant before the indemnity is triggered. Importantly, this form of indemnity, subject to one qualification, does not extend the tenant's exposure beyond that for which it would be liable, because the common law of negligence would apply in any event (this is especially significant in the context of Comcover insurance: see p 13).

Legal costs under indemnities
Even where an indemnity is triggered by the tenant's negligence and therefore seemingly goes no further than the common law, it can go further in relation to the award of costs following a court case. Generally, after one side wins a court case it will be awarded costs, but the winning party does not usually get 100% of those costs. However, under this indemnity the landlord

would be entitled to 100% of its legal costs. So, commercially, the indemnity does go a little further than the common law in that respect. But it does not expose the tenant to liabilities by way of additional causes of action.

Meaning of 'suffers or incurs'

In the case of the broader 'suffers or incurs' wording, though, the indemnity could result in the tenant incurring liability for which it would not otherwise have been liable. The expression 'arising out of the tenant's use and occupation' is broad enough to capture those things which are not actionable but which nevertheless cause the landlord loss. For example, if the tenant builds a structure on the land with the landlord's consent which blocks out the light and air flow to a neighbouring tenant, and that tenant successfully sued the landlord for derogating from the grant of its lease, the landlord may be able to recover the lost rent from the tenant, despite the landlord's earlier consent.

Proportionate liability legislation

The scope of the tenant's liability may also be affected by proportionate liability legislation in the relevant jurisdiction. Some jurisdictions (for example, Queensland) have proportionate liability regimes that cannot be contracted out of. This may mean that a party's liability is limited to its share of responsibility for another party's loss, irrespective of the form of indemnity contained in an agreement between those parties. As different proportionate liability legislation has been introduced in each jurisdiction, it is important to examine the regime applicable to the jurisdiction relevant to each individual contract. For further information regarding proportionate liability, please see AGS Commercial note No. 23 (30 May 2007; updated 30 October 2007).

Even standard form indemnities need careful consideration

Indemnities come in all shapes and sizes, although the wording (especially in similar classes of legal agreement) can be similar. Nonetheless, it is important to examine the terms of an indemnity before allowing its insertion into a contract, because seemingly innocuous indemnities have the potential to markedly increase risk exposure. Moreover, they are not necessarily labelled as indemnities in the contract.

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An example is a clause which indemnifies a specialist contractor for all liability 'arising out of the provision of the specialist services'. The services are being provided for the agency and it has agreed to indemnify the specialist contractor in respect of liability arising out of the provision of the services. However, its terms are arguably wide enough to cover acts of the contractor which are fraudulent, reckless or negligent. So, if the consultant was fraudulent and incurred liability because of that fraud, he or she could arguably seek recourse for the loss from the agency.

Commonwealth indemnities in favour of a contractor

In the sphere of Commonwealth contracting, Commonwealth indemnities are particularly significant because the legal, policy and financial framework within which Australian Government agencies enter into contracts gives specific recognition to, and has specific policies intended to deal with, Commonwealth indemnities.

Indemnities are considered from a number of different perspectives

In assessing an indemnity in the Commonwealth context, there are a number of relevant perspectives, all of which are closely related to each other. The Department of Finance and Deregulation identifies at least five perspectives that agencies should consider, as articulated in Financial Management Guidance documents:

— First, there is the *commercial* or *financial* perspective of an individual agency: what are the commercial or financial implications for the agency, acting on behalf of the Commonwealth, in granting an indemnity to a contractor in relation to a particular contract? That is, what is the potential cost to the affected agency of this commitment requested by the contractor?

— Second, what are the implications of a proposed indemnity from a *financial framework* perspective? This deals with the requirement to undertake a risk assessment, obtain agreement and approval under any applicable regulations and consider Commonwealth and departmental policies in approving proposed spending proposals that contain contingent liabilities.

— Third, what are the implications of granting a proposed indemnity on the *insurance coverage* enjoyed by an Australian Government agency?

— Fourth, what are the implications of a proposed indemnity from a broader *Commonwealth policy* perspective? For example, is the indemnity contrary to other Australian Government policy, such as policy relating to particular industry sectors? A further consideration is whether it is likely to set an undesirable precedent.

— Fifth, what is the potential impact on the wider *Commonwealth budget* should an indemnity crystallise? Indemnities entered into by individual agencies can affect the Commonwealth as a whole if their cost cannot be met from that agency's appropriations.

The second and third perspectives are discussed later in this briefing. It should be emphasised that the consequence of the first perspective is that a decision to grant an indemnity by the Commonwealth is a commercial or financial decision, not a legal decision, although an informed commercial or financial decision will often be made with the assistance of legal advice.

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Legislative and policy framework for Commonwealth indemnities

A complete description of the Commonwealth financial framework is beyond the scope of this briefing. For this reason, the following discussion focuses on the key aspects of the financial framework relevant to risk, liability and indemnities.

The financial framework is underpinned by the *Financial Management and Accountability Act 1997* (Cth) (FMA Act), the *Financial Management and Accountability Regulations 1997* (Cth) (FMA Regulations), and the Finance Minister's Orders.

FMA legislation

The FMA Act provides the following:

— Section 44 of the FMA Act states that the chief executive of an agency must manage the affairs of the agency in a way that promotes 'proper use' of Commonwealth resources.

— Note that 'proper use' means efficient, effective and ethical use that is not inconsistent with the policies of the Commonwealth.

The FMA Regulations provide the following:

- The chief executive of an agency is authorised to give instructions (called Chief Executive's Instructions or CEIs) to officials in that agency on various matters relating to the FMA Act, including 'making commitments to spend public money' and 'acquiring property that is to be public property' (FMA Regulation 6).
- The Finance Minister may issue Commonwealth Procurement Guidelines (CPGs) and an official performing duties in relation to procurement must act in accordance with the CPGs (FMA Regulation 7)
- The Finance Minister may issue Commonwealth Grant Guidelines (CGGs) and an official performing duties in relation to grants administration must act in accordance with the CGGs (FMA Regulations 7A).
- A person must not enter into an arrangement unless a spending proposal has been approved under FMA Regulation 9 and, if required, written agreement has been given under FMA Regulation 10 (FMA Regulation 8).

    An 'arrangement' refers to contracts, agreements or arrangements under which public money is, or may become, payable. The following arrangements are expressly excluded from the definition of arrangements[4]:

    - engagement of employees;
    - appointment of statutory office holders;
    - acquisition of particular property or services under a general arrangement with the supplier of that property or those services, for the purposes of providing a statutory or employment entitlement; or
    - entering into an international agreement (such as a treaty) governed by international law.

- Note that if agreement under FMA Regulation 10 is required it does not need to be given before the proposal is approved under FMA Regulation 9.
- An approver must not approve a spending proposal unless they are satisfied after making reasonable inquiries, that it would be a proper use of Commonwealth resources (FMA Regulation 9).

Indemnity Guidelines

Indemnity Guidelines must be complied with for FMA Regulation 9 approval

The Indemnity Guidelines were published in September 2003 as *Financial Management Guidance No. 6* in conjunction with Finance Circular 2003/02, *Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort*.

The Indemnity Guidelines are a policy of the Commonwealth, and approvers are required by FMA Regulation 9 to ensure that expenditure is not inconsistent with the Indemnity Guidelines when considering whether to approve proposals to spend public money. As with other instances of non-compliance with the FMA Act, Regulations and other specified financial management policy, there is a requirement that non-compliance must be reported in the agency's Certificate of Compliance.[5]

The Indemnity Guidelines essentially divide indemnities into two classes:

- losses or damages for which the Commonwealth may otherwise be liable even in the absence of an indemnity
- losses or damages for which the Commonwealth would not otherwise have been liable without having issued an indemnity.

The Indemnity Guidelines state (at p 7):

> The Australian Government's policy on issuing indemnities, guarantees, warranties and letters of comfort is to accept such risks only when the expected benefits, financial or otherwise, are sufficient to outweigh the level and cost of the risk which the Commonwealth would be assuming. As a matter of principle, risks should be borne by those best placed to manage them – that is the Australian Government should generally not accept risks which another party is better placed to manage.

Significantly, the Indemnity Guidelines emphasise that there needs to be an explicitly identified risk before an indemnity may be granted.

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Relevant factors for Indemnity Guidelines[6]

The Indemnity Guidelines set out an extensive list of factors that should be taken into account before an indemnity is provided, including mitigation measures and alternatives such as:

- time limits on the indemnity (for example, to claims made during the term of the contract)
- use by the contractor of commercial insurance
- reserving a termination right for the Commonwealth
- the imposition of maximum financial limits on claims
- the insertion of subrogation and notification clauses that give the Commonwealth the right to take over any litigation related to the indemnity.

There is also a recommendation that the indemnity does not cover damage from acts by the indemnified person which are 'malicious, fraudulent, wilful, illegal, reckless etc'. This policy mirrors the *Corporations Act 2001* (Cth), ss 199A–199C, and the *Commonwealth Authorities and Companies Act 1997* (Cth), ss 27M–27P, which limit the circumstances in which Commonwealth companies and authorities may indemnify officers against their own conduct and insure them in respect of liabilities arising out of that conduct.

Requirement to seek legal advice

The Indemnity Guidelines contain a further recommendation that legal advice should be sought, where appropriate, to ensure that the Commonwealth is exposed to the minimum risk necessary to achieve the particular objective. The questions on which legal advice is suggested to be sought are very comprehensive. They include:

- whether any applicable legislation restricts the scope of executive power of the Commonwealth to enter into the arrangement (more likely to be applicable to loan guarantees than to indemnities: see FMA Regulation 11)
- whether the party to be provided with the indemnity is actually exposed to the purported risks and what the potential liabilities could be
- the extent to which the proposed indemnity protects another party against liabilities imposed on them by common law or legislation – if this is the case, the indemnity should be excluded unless there is a clear justification for the agency giving it
- whether the proposed indemnity only seeks to replicate liabilities imposed on the Commonwealth by common law or Commonwealth legislation – if so, as noted above, the Indemnity Guidelines state that the provision is redundant and should be excluded unless there is a clear justification for

the agency granting the indemnity (an agency may, for example, take the view that normal industry practice or likely additional costs constitute 'clear justifications')

— the extent to which FMA Regulation 10 applies.

Risk management under the Indemnity Guidelines

A persistent theme in the Indemnity Guidelines is one of effective risk management. A number of requirements either directly or implicitly contemplate that the risk identification and assessment process has been carried out. There are references to indemnities being granted only in respect of 'explicitly identified risks'; to 'the expected benefits objectively outweighing the level and costs of the risks'; to agencies having 'assessed the specific risks to be covered'; to potential losses having been 'rigorously investigated and identified'; and to appropriate risk management arrangements being in place.

All of these references assume appropriate risk assessment and management. The Indemnity Guidelines provide a brief outline of appropriate risk management processes, but for more detail agencies should consult AS/NZS ISO 31000:2009, *Risk management – Principles and Guidelines*[7] and the *Liability Risk Assessment Guide for FMA Act Agencies* which is discussed further below.

Commonwealth Procurement Guidelines

The CPGs make it clear that, as a general principle, risk should be borne by the party best placed to manage risk: an agency should not generally accept risks that another party is best placed to manage and should not seek to transfer risks that it is best placed to manage to a contractor. The CPGs also note that the extent of risk management should be commensurate with the type of procurement process. They emphasise that agencies should consider risk:

— at the commencement of a procurement process

— when deciding upon the appropriate procurement method to use

— when determining the relative value for money of proposals

— throughout the course of a project including in relation to relationship management, contract management and termination/transition management.

Importantly, the CPGs require that agencies must undertake a risk assessment as an initial exercise when considering whether granting an indemnity would be appropriate and, if it is appropriate, what limits on the indemnity would be suitable. The agency should develop and implement a risk management plan if an indemnity is given.

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The CPGs also recommend that request documents for more complex processes include draft contracts with clear liability provisions against which tenderers should indicate compliance and that alternative liability regimes proposed by tenderers should be priced.

FMA Regulations 10 and 10A

In addition to FMA Regulation 9 considerations, if a person proposes to enter into an arrangement and the relevant Agency has an insufficient appropriation of money, under the provisions of an existing law or a proposed law that is before Parliament, to meet *expenditure that might* *be payable under the arrangement* the person must not enter into the arrangement unless the Finance Minister has agreed, in writing, to the expenditure that might become payable under the arrangement.

— Note that if an agency gives an indemnity, amounts that could be required to be paid under the indemnity are 'expenditure that might be payable under the arrangement'. An obligation to pay money under an indemnity is a contingent liability.

FMA Regulation 10A provides an exception to the requirement to obtain FMA Regulation 10 agreement for contingent liabilities (such as indemnities) where the person proposing to enter the arrangement is satisfied, after making reasonable inquiries, that:

(i) the likelihood of the event occurring is remote (less than 5% chance); and

(ii) the most probable expenditure that would need to be made in accordance with the arrangement, if the event occurred, would not be material (less than $5 million or another amount specified by the Finance Minister).[8]

Note that a risk assessment is required to assess the value of the contingent liability and the likelihood of the contingent liability being realised, while also providing information about the possible mitigation of the risk being accepted under the contingent liability. The type and complexity of a risk assessment should be commensurate with the arrangement. For example, an agency which enters into a number of venue-hire agreements that contain the same indemnity and have similar legal risks may well undertake a single assessment for all venue-hire agreements. Agencies must still comply with the Indemnity Guidelines even if FMA Regulation 10A exempts an indemnity from the requirements of FMA Regulation 10.

Obtaining FMA Regulation 10 agreement for an arrangement with a Commonwealth indemnity

If the operation of FMA Regulation 10 has been triggered, and FMA Regulation 10A does not apply, the written agreement of the Finance Minister is required.

FMA Regulation 10 agreement can be obtained in three ways:

— under the FMA Regulation 10 delegation

— under an agency-specific determination

— from the Finance Minister.

The Department of Finance and Deregulation has advised that the FMA Regulation 10 delegation and related guidance such as Finance Circular 2007/01 are expected to be reissued to take account of the amendments to the Financial Management and Accountability Regulations which took effect on 1 July 2010. In the mean time, the current FMA Regulation 10 regulation delegation continues to be available for those situations covered by the delegation which are not covered by FMA Regulation 10A.

FMA Regulation 10 delegation [9]

The Finance Minister has delegated the exercise of his power in certain circumstances, with conditions, to agency chief executives.

The delegation contains a number of directions that must be followed by delegates considering whether to grant agreement under FMA Regulation 10. For example, it includes provision for a delegate to give an FMA Regulation 10 agreement under the delegation where all of the following are satisfied:

- the spending proposal includes a contingent liability of the Commonwealth that is an integral part of the spending proposal
- the spending proposal, apart from the presence of the contingent liability, would otherwise satisfy the requirements of the delegation for the agreement of departmental spending proposals or administered spending proposals (for example, in relation to amount and duration of expenditure under the proposal)
- the specific indemnity related requirements of the delegation are complied with.

Agencies contemplating seeking agreement under the delegation should also consult their CEIs for agency-specific guidance to delegates, and the scope of the delegation. If necessary, legal advice should be sought as to whether agreement can be given under the delegation.

FMA Regulation 10 agency-specific determinations

Agencies should also note that it is possible to seek a determination from the Finance Minister that varies the limits of the delegation to address specific circumstances.

FMA Regulation 10 agreement from the Finance Minister

Where a spending proposal does not fit within the scope of the delegation or an agency-specific determination, agreement from the Finance Minister will be required. Agencies should consider the timeframe and procedural steps required in order to obtain such an agreement in developing their procurement timetable and strategy.

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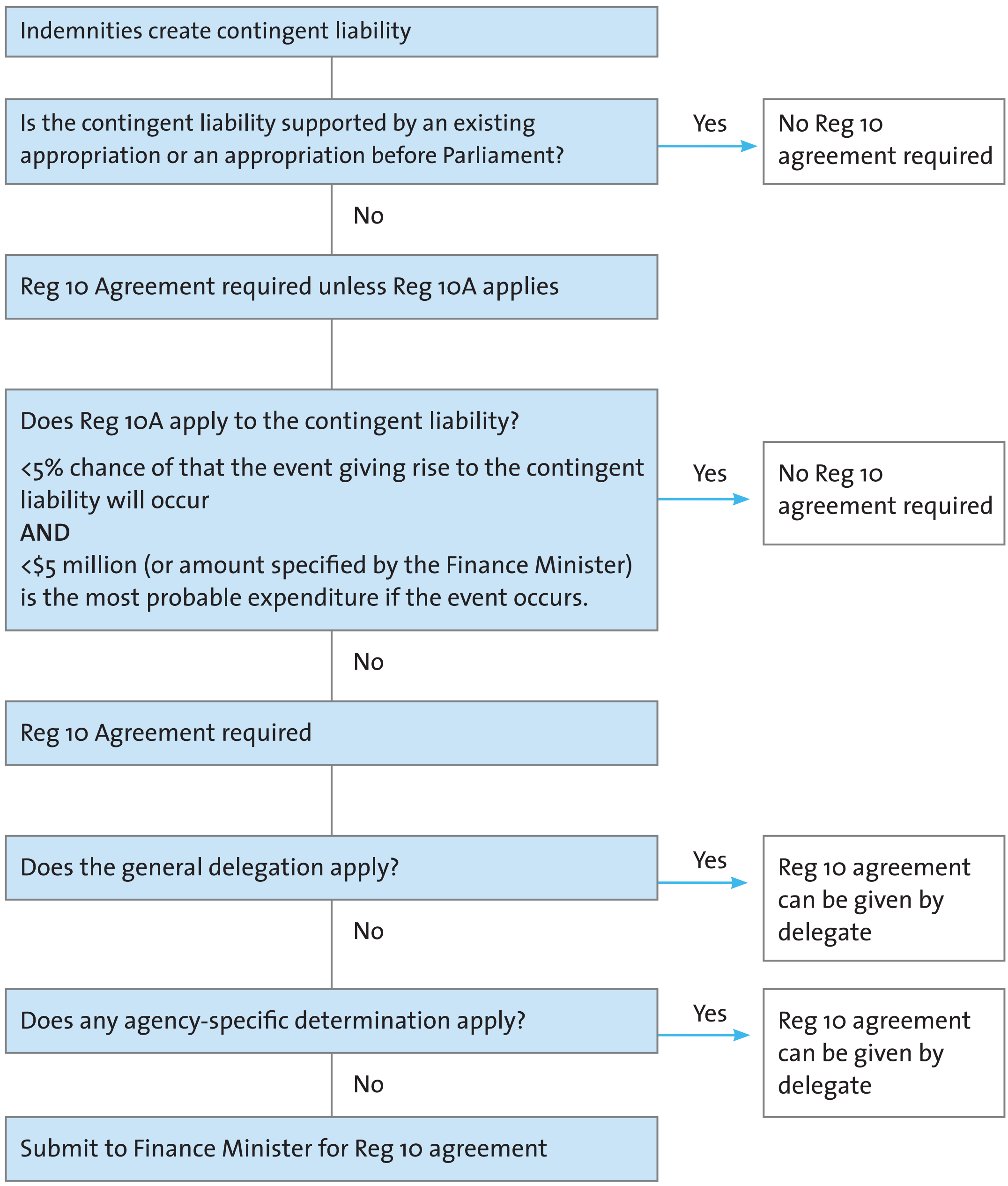
FMA Regulation 10 and Indemnities



Chief Executive's Instructions

Specific guidance to an Agency's officers on financial management can be provided by the Chief Executive's Instructions (CEIs) issued by the agency's chief executive under FMA Regulation 6. CEIs are legally binding upon the officers of that agency under the FMA legislation.

To assist agencies in developing their own CEIs see Finance Circular 2004/15: *Chief Executive's Instructions* attaches *Guidance on the Development of Chief Executive's Instructions*, which assumes that agency CEIs will contain a section on contingent liabilities (including indemnities).

Although agency-specific, in terms of providing guidance and instruction to officers on Commonwealth procurement policies and practice (including managing risk) CEIs largely encapsulate and expand upon the FMA legislation, CPGs and relevant Finance circulars.

Summary of the financial framework

The combined effect of the requirements of the financial framework and relevant Commonwealth policies is that agencies that are requested to provide an indemnity to another party should do the following:

- **Carry out a risk assessment to determine whether an indemnity should be provided – this can be done on a transaction specific basis or might be done for a group of routine transactions, such as venue-hire, with the same risk profile, for example. The type and complexity of the assessment should be commensurate with the arrangement/s.**
- **Apply the principle that the party best placed to manage a risk should be responsible for that risk.**
- **If an indemnity is to be granted, seek to limit any potential liability under the indemnity (for example, by including financial caps and time limits) where appropriate.**
- **Seek appropriate approvals or agreements before entering into an indemnity and meet all reporting and disclosure requirements.**
- **Actively manage the risks associated with the indemnity through development and implementation of a risk management plan to reduce the likelihood of it being called upon.**
- **Only accept risks where the expected benefits, financial or otherwise, are sufficient to outweigh the level and cost of the risk which the Commonwealth would be assuming.**

Comcover considerations for Commonwealth indemnities

It is beyond the scope of this briefing to comprehensively discuss the relationship between risk management and insurance.[10] However, that relationship is obviously an aspect of risk management. This was given fresh impetus with the establishment of Comcover, the insurable risk-managed fund, in 1998. The then Finance Minister, in announcing Comcover, stated:

> The policy of non-insurance, which has been in place since 1909, offers little incentive for public sector organisations to manage their risks effectively. The introduction of the new fund will, for the first time, require the systematic identification, quantification, reporting and management of risk across Commonwealth departments and agencies.

Many contingent liabilities are uninsurable by nature, but agencies need to have regard to those risks that are insurable risks in accordance with Comcover's policy terms and conditions. It should be noted that Comcover, as part of its risk management services, provides advice to Commonwealth agencies on how to effectively manage risks and assists in seeking to instil a proper risk management culture via education programs and regular risk assessments. In June 2008, Comcover released a *Better Practice Guide on Risk Management*.

Agencies need to have regard to those risks that are insurable risks in accordance with Comcover's policy terms and conditions.

From a practical perspective, agencies that intend to provide indemnities should be aware of Comcover policy condition 2.13.2, which excludes from coverage 'liability arising out of any indemnity unless the liability would have arisen in the absence of such indemnity'. In other words, Comcover does not cover any liability under an indemnity beyond that for which an agency would have otherwise been liable unless specific approval is obtained from Comcover beforehand. One consideration in relation to whether coverage will be granted is whether the Indemnity Guidelines have been complied with (see Comcover policy part 3.5).

The Comcover policy does contain an exception to the exclusion, provided the Indemnity Guidelines have been adhered to. The exception applies to:

— indemnities contained in a contract for a short-term venue hire or motor vehicle hire whereby the agency has assessed that the probability of liability is remote, and the residual risk (excluding the risk control of insurance) is no more than $20 million, or

— where FMA Regulation 10 agreement is not required.

Note that there is also an exception for indemnities entered into prior to 1 July 2004.

Please refer to footnote 25 on page 31 of the Comcover Insurance Policy 2010/2011 for further information.

As noted above, an adequate assessment of whether an indemnity does go beyond (rather than merely restates) the common law position requires an understanding that liability can arise from different sources (and not just breach of contract).

It should be noted that the presence of insurance, whether through Comcover or a commercial insurer, does not affect the need for appropriate agreements and approvals in accordance with the FMA Regulations for the full amount that may become payable under the arrangement.

Commonwealth indemnities tips

- The decision to grant an indemnity must be informed by an agency's commercial objectives and wider Commonwealth policy objectives.
- Consider the wording of an indemnity carefully, even if it is a standard form indemnity, as small changes to wording can make a big difference to liability.
- Always undertake a risk assessment.
- Discuss any proposed Commonwealth indemnity with Comcover.
- Spending proposals that contain indemnities must be approved under FMA Regulation 9.
  - — Where a contract contains a Commonwealth indemnity, this creates a contingent liability. Contingent liabilities have to be taken into account in quantifying the spending proposal for the purposes of FMA Regulation 9.
  - — There are guidelines for issuing and managing indemnities that must be followed for the spending proposal to be approved under FMA Regulation 9. Under these guidelines, agencies should seek to limit any potential liability (for example, by including financial caps and time limits) where appropriate.
- Written agreement from the Finance Minister in accordance with FMA Regulation 10 may be required.
  - — In addition to FMA Regulation 9 approval, any arrangement (including contingent liabilities) that is not fully supported by an appropriation requires agreement under FMA Regulation 10 unless FMA Regulation 10A applies.
  - — FMA Regulation 10 agreement for indemnities may sometimes be given under the delegation from the Finance Minister.
  - — If the delegation is not available, in most cases agreement from the Finance Minister will be required. Take this into account in planning the procurement/contracting process.

Contractor indemnities and liability caps

This briefing has so far looked at the Commonwealth's liability to the contractor, particularly where the Commonwealth grants an indemnity to the contractor. In this section we look at the contractor's liability to the Commonwealth.

Typically, Commonwealth contracts will contain an indemnity from the contractor to the Commonwealth. The principles discussed above about the 'who', 'what', 'when' and 'how' of indemnities (see p 4) are equally relevant to indemnities provided by contractors.

A liability cap is a contractual provision which caps the liability of one contracting party to the other contracting party under the contract to a certain amount.

What is a liability cap?

One of the most common issues that arises in relation to a contractor's liability to the Commonwealth is the issue of liability caps. A liability cap is a contractual provision which caps the liability of one contracting party to the other contracting party under the contract to a certain amount.

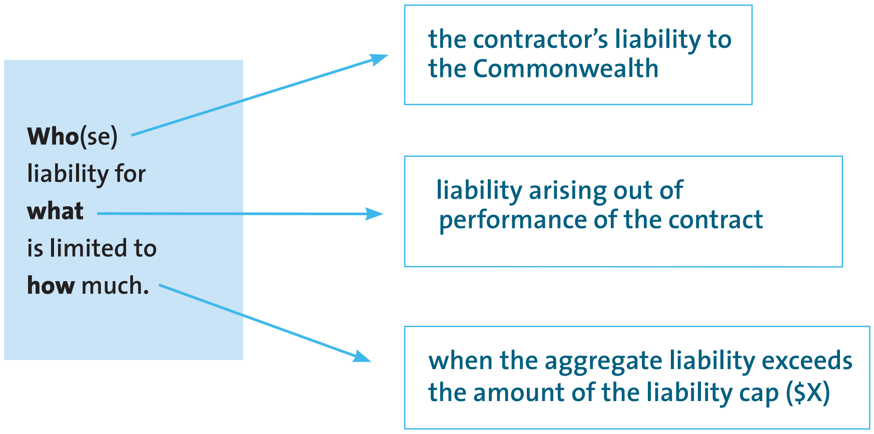
Anatomy of a liability cap

A useful way of looking at liability caps is to break them down into the following three components: 'who', 'what', and 'how (much)'.

Example

A contractor requests a liability cap in the following terms:

> The aggregate liability of the contractor to the Commonwealth arising out of the contractor's performance of the contract is $X.



Who gets the benefit of the liability cap?

A liability cap benefits the party whose liability is being capped, which in this case is the contractor. In respect of liabilities covered by the cap, the contractor's liability to the Commonwealth will be limited to the amount of the cap. The Commonwealth will bear the risk for all amounts above the amount of the cap.

What does the liability cap cover?

This refers to the types of liability covered by the liability cap. In this case, the liability cap is very broad and does not restrict the types of liabilities covered provided that they arise out of performance of the contract. This could include claims for breach of contract, negligence or statutory claims. Note also that unless the liability cap is linked to the contract in some way, the cap may be taken to apply to liabilities the contractor has to the Commonwealth that have nothing to do with the contract.

In most cases, the liability cap will be drafted so as to exclude certain liabilities for which the contractor is to retain unlimited liability. For example, the Commonwealth's policy in relation to liability caps in information and communications technology (ICT) contracts lists a range of liabilities that should ordinarily be excluded from the operation of liability caps in ICT contracts. This policy is discussed further below.

In most cases, certain liabilities will be excluded from the operation of the liability cap.

It is important to consider the relationship between the liability cap and other provisions of the contract. For example, a liability cap in one part of the contract may limit an indemnity contained in another part of the contract.

Liability caps sometimes limit or exclude liability for 'consequential loss'. A recent Victorian Court of Appeal case indicates that the term 'consequential loss' is likely to cover 'everything beyond the normal measure of damages, such as profits lost or expenses incurred through breach'.[11]

How much: i.e. how should the liability cap be set?

The liability cap will apply where the amount of the contractor's liability exceeds the amount of the cap. In this case, the amount of the liability cap is $X. As the clause provides that this is the 'aggregate liability' of the contractor, $X is the total amount for which the contractor will be liable to the Commonwealth in respect of liabilities that are covered by the cap. Liability caps can also be made to apply on a per event basis or on aggregate basis over a certain period of time. Sometimes the parties agree to both a per event cap and an aggregate cap.

Liability caps are usually triggered when the party whose liability is being capped incurs a liability to the other contracting party in relation to the contract. In this case, the cap is triggered by liabilities of the contractor to the Commonwealth 'arising out of the contractor's performance of the contract'.

Another type of cap that should be avoided is capping liability to what the contractor can recover from insurance. This type of cap is fraught with difficulty because it is likely to be reliant on:

— the detailed terms and conditions of the contractor's insurance policy (and, in particular, it is subject to any exclusions set out in the policy)

— the contractor actually complying with the requirements of the policy so as not to void the insurance.

As a result of its activities under the contract, the contractor may be liable to the Commonwealth for loss, damage or expense that the Commonwealth has suffered directly (for example, for damage to Commonwealth property) or indirectly (for example, for claims by third parties against the Commonwealth for third party loss as a result of the contractor's actions). The only way to properly determine an appropriate amount for a liability cap is through a risk assessment.

The financial framework and Commonwealth Guidelines and Policies

Like all provisions of the contract, a liability cap will need to be considered in the context of the FMA Regulation 9 approval for the spending proposal. In some cases it will also require FMA Regulation 10 agreement. There are a number of Commonwealth policies and guidelines to consider in relation to liability caps.

Liability Risk Assessment Guide for FMA Act Agencies

The *Liability Risk Assessment Guide for FMA Act Agencies* is an important resource for risk assessment of FMA Act agencies undertaking procurements. It assists procurement officers through the liability risk assessment process to correctly allocate and limit liability, assess supplier proposals and arrive at justifiable levels of insurance. It includes a model clause which sets out an explanation of what the supplier will be liable for under the contract and reflects an allocation of liability between the supplier and the Commonwealth. In the procurement setting this may be an appropriate clause to effectively allocate risk between FMA Act agencies and their suppliers. Importantly, this Guide stresses where an agency is best placed to manage the risk it should not seek to inappropriately transfer that risk to a supplier. Likewise, agencies should generally not accept financial liability for risk which another party is better placed to manage.[12]

Commonwealth Procurement Guidelines requirements

The CPGs provide that proposed limitations on liability should be considered in a similar way to indemnities (see p 9). That is, a risk assessment is required to identify whether to agree to a cap and also what would constitute an appropriate limit. Further, liability caps are relevant to the determination of value for money and, if a decision to limit liability is taken, a risk management plan should be developed.

Indemnity Guidelines

Agencies must also comply with the Indemnity Guidelines (including the requirement to undertake a risk assessment) before approving a spending proposal that involves a contingent liability (see Finance Circular 2007/01).[13]

Legal advice may be required

To assist in determining whether FMA Regulation 10 agreement is required where a liability cap is proposed, Finance Circular 2007/01 states that agencies may need to consider obtaining legal advice to clarify the scope of the proposed liability cap.

Liability caps in information and communications technology contracts

Both the CPGs and the Indemnity Guidelines provide that risks should generally be borne by the party best placed to manage them.

This principle would dictate that, in general, where a contractor is better placed to manage the risk associated with its provision of goods or services to the Commonwealth, the contractor's liability to the Commonwealth in respect of that risk should not be limited by contract. However, as a matter of Commonwealth policy, liability caps in ICT contracts are a specific exception.

Finance circular 2006/03: *Limited Liability in Information and Communications Technology Contracts* (found at http://www.finance.gov.au/publications/finance-circulars/2006/03.htm) sets out the policy relating to limiting the liability of ICT suppliers contracting with the Commonwealth. The Department of Innovation, Industry, Science and Research publication *A Guide to Limiting Supplier Liability in ICT with Australian Government Agencies* (Second Edition, May 2010) assists agencies to implement the ICT liability policy.

For the purpose of this policy, a cap on supplier's liability is defined as an arrangement whereby a supplier's liability for damage or loss incurred by the Commonwealth is limited to a certain amount. A liability cap only applies to the parties to the contract and does not include:

— limiting the supplier's liability to compensate a third party, or

— compensating the supplier for damage suffered directly by the supplier.

The Australian Government policy is that the liability of ICT suppliers should in most cases be capped at appropriate levels, based on the outcomes of a risk assessment, particularly in relation to:

— standard breach of contract in relation to service delivery obligations

— contractor liability arising from negligent acts or omissions (other than negligent acts or omissions in relation to the matters specified below).

However, it is generally appropriate (unless there is a compelling reason otherwise) for agencies to retain unlimited liability clauses in ICT contracts relating to personal injury (including sickness or death), unlawful or illegal acts, damage to tangible property, intellectual property obligations, confidentiality and privacy obligations, and security obligations.

Notwithstanding this unique treatment of liability caps in relation to ICT contracts under Commonwealth policy, FMA Regulation 10 agreement may still be required if the exception in FMA Regulation 10A is not applicable (see below) and the CPGs and the Indemnity Guidelines should otherwise be complied with in the process of determining whether to agree to such a cap. In particular, a risk assessment should be undertaken and legal advice appropriate to the complexity of the purchase and the level of risk should be obtained in relation to liability caps in ICT contracts.

Do liability caps trigger the need for FMA Regulation 10 agreement?

Whether a liability cap triggers the need for FMA Regulation 10 agreement depends on the kinds of liability limited by the cap.[14]

Whether a liability cap triggers the need for FMA Regulation 10 authorisation depends on the kinds of liability limited by the cap.

According to Finance Circular 2007/01[15], spending proposals containing the following types of liability cap will be regarded as contingent liabilities and will generally, depending on the limits of the relevant appropriation, (and the application of FMA Regulation 10A), require FMA Regulation 10 agreement:

— liability caps limiting a contractor's liability to a third party so that the Commonwealth is liable to the third party for any excess

— liability caps limiting a contractor's exposure for damage the contractor has itself suffered so that the Commonwealth is liable to the contractor for any excess

— liability caps limiting a contractor's liability to meet costs that the Commonwealth may seek to recover from the contractor, where a third party has sued the Commonwealth for damage resulting from the contractor's action or inaction.

However, if a liability cap only limits a contractor's liability to the Commonwealth for damage that the contractor directly causes the Commonwealth, the Commonwealth's policy in Finance Circular 2007/01 is that the liability cap will not, of itself, result in a need to obtain FMA Regulation 10 agreement.

For the circumstances where FMA Regulation 10A might be applicable see page 10.

Comcover considerations for liability caps

Agencies should also be aware that the Comcover policy provides for Comcover to be subrogated to the rights of the agency when a claim payment is made. It may be a breach of the policy to agree to a proposed liability cap without disclosing that fact to Comcover under condition 2.13.2 on the basis that the agency has 'otherwise compromised [the agency's] legal position'. This may entitle Comcover to refuse to indemnify the agency. AGS sought clarification from Comcover on this issue, and Comcover's reply was as follows:

It may be a breach of the policy to agree to a proposed liability cap without disclosing that fact to Comcover ...

> It must be stressed that the decision to include a liability cap within a contract is entirely the responsibility of the agency involved. There is no requirement to obtain Comcover approval for liability caps. However, if the liability cap relates to an insurable risk and the agency wishes Comcover to fund potential losses arising out[side] of the cap, then approval must be sought for Comcover's agreement to waive its right of subrogation. This approval must be sought in advance and provided in writing.

Liability caps for damage to other agencies' property

There are some additional considerations for agencies if they are considering capping a contractor's liability for damage to Commonwealth property that is not the responsibility of the agency. Section 44 of the FMA Act states that a chief executive must manage the affairs of the agency in a way that promotes the efficient, effective and ethical use of Commonwealth resources for which the chief executive is responsible. Therefore, when determining whether there is sufficient justification to issue a liability cap that limits a contractor's liability for damage to Commonwealth property for which that chief executive is not responsible, the Department of Finance and Deregulation advises that the risk assessment should consider the impact on other agencies.

The Department also advises that, if the liability cap is likely to affect a small number of agencies, the chief executive should consider consulting with those agencies. If the liability cap is likely to affect all agencies, the chief executive should consider consulting with Finance.

This is in addition to any requirements under Regulation 9 that a spending proposal must not be approved unless, among other things, it is not inconsistent with the policies of the Commonwealth.

In addition, an agency's Comcover policy relates to the insurable risks for which that agency is responsible. If a proposed liability cap relates to insurable risks for which another agency is responsible then Comcover may need to consult that agency. This can arise where a liability cap is expressed to encompass damage to Commonwealth property and, in the circumstances of the particular contract, there is a potential for the contractor to cause damage to Commonwealth property administered by more than one Commonwealth agency.

If a proposed liability cap relates to insurable risks for which another agency is responsible then Comcover may need to consult that agency.

Contractor insurance considerations

This briefing does not look in any detail at commercial insurance, which is a substantial area in its own right. However, agencies should be aware that, in the context of Commonwealth contracts, the primary purpose of requiring the contractor to hold commercial insurance in relation to particular liabilities is to ensure that the contractor will have the necessary resources to meet any liabilities that arise as a result of the contract. Agencies should bear in mind the following:

- The availability of commercial insurance and a contractor's insurance limits should be considered as part of the risk assessment.
- The fact that a person is required to hold insurance for a particular type of liability does not of itself make them liable for that type of liability. The common law, legislation or the terms of the contract will determine if that liability exists.
- Agreement to a certain level of insurance does not generally equate to agreement to limit liability to that level. Agencies need to take care to avoid any misunderstandings about this issue.
- Commercial insurance policies often contain a range of terms and conditions which can impact on whether or not a claim may be made in particular circumstances. This can have a significant bearing on the effectiveness of the policy.
- In some cases, it is necessary to obtain specialist insurance advice in relation to proposed insurance arrangements for contractors.

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Liability caps checklist

- As with indemnities:
  - — a risk assessment must be undertaken and, if necessary, a risk management plan implemented
  - — remember that risk should generally be borne by the party best placed to manage the risk
  - — the decision whether to agree to a liability cap must be informed by an agency's commercial objectives and wider Commonwealth policy objectives
  - — the Indemnity Guidelines should be complied with if the liability cap creates a contingent liability
  - — some liability caps may require FMA Regulation 10 agreement (although FMA Regulation 10A may be applicable)
  - — it may be possible for that agreement to be provided under the delegation from the Finance Minister.
- There is a specific policy in relation to capping contractor liability in ICT contracts.
- Where a liability cap affects more than one agency, it may be prudent to discuss it with other affected agencies or the Department of Finance and Deregulation.
- It is prudent to discuss liability caps with Comcover.
- Take care with the relationship between contractor indemnities, liability caps and contractor insurance.

This briefing is based on the 2006 Legal briefing 79, Indemnities in Commonwealth Contracting *(by Linda Richardson, Andrew Miles and Shaun Tipson) and an updated version, published as Legal briefing 86 in July 2006 (by Linda Richardson, Andrew Miles, Kathryn Evans and Cathy Reid) and again in January 2009 (by Linda Richardson, Paul Lang and Cathy Reid).*

Linda Richardson *is the National Leader of our Commercial Practice and has extensive expertise in commercial work, specifically government tendering and contracting and Commonwealth accountability. She has significant experience as a negotiator of commercial and government-to-government agreements, has drafted best practice guidance for various agencies and recently assisted in the development of the* Liability Risk Assessment Guide for FMA Act Agencies *for the Department of Innovation, Industry, Science and Research.*

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Summary

The main points in this briefing are as follows:

- The decision to provide a Commonwealth indemnity or a cap on contractor liability is not a legal decision, although it will often need to be informed by sound legal advice.
- Indemnities require compliance with the CPGs and the Indemnity Guidelines.
- Risks should be allocated to the party best placed to manage them.
- It is not enough to say that a contractor has sought an indemnity or a liability cap; agencies need to go that further step and analyse the risks accepted under the indemnity or the liability cap.
- In carrying out indemnity risk assessments, agencies should consider the anatomy of the indemnity by reference to the four-step analysis ('who', 'what', 'when' and 'how') described on p 4.
- Follow the Indemnity Guidelines, particularly in relation to when a Commonwealth indemnity may be granted, the conditions which should be included and when to seek legal advice.
- Some Commonwealth indemnities trigger the need for FMA Regulation 10 agreement unless the exception in FMA Regulation 10A applies.
- In some cases, FMA Regulation 10 agreement can be sought from within the agency under the FMA Regulation 10 delegation, but, in other cases, it may need to be sought from the Finance Minister.
- Liability caps which create a contingent liability require compliance with the Indemnity Guidelines and may trigger FMA Regulation 10, depending on the limits of the relevant appropriation and whether FMA regulation 10A is applicable. The policy relating to capping liability in ICT contracts does not obviate the need for FMA Regulation 10 agreement.
- Finally, and most importantly, whether one is dealing with the legal, commercial, insurance or financial aspects of liabilities and indemnities, a risk assessment is required. The *Liability Risk Assessment Guide for FMA Act Agencies* provides some useful guidance on this.

Notes

1 This briefing uses 'agencies' to refer to agencies that are subject to the FMA regime. However, much of the discussion is also applicable to *Commonwealth Authorities and Companies Act 1997* (Cth) bodies in that it represents a prudent approach to the question of risk management.

2 Standards Australia, Australian/New Zealand Standard AS/NZS ISO 31000:2009, Risk management – Principles and guidelines.

3 This briefing uses the word 'damage' – which implies a negative consequence – because this is the type of risk that is most often managed contractually. For completeness, note that AS/NZS ISO 31000:2009 defines 'risk' to include events that have both positive and negative outcomes. These positive (and less often analysed) risks are often referred to as 'opportunities'.

4 Note that an arrangement which falls within the following categories but also includes a contingent liability may not be excluded from the definition to the extent of the contingent liability.

5 See Finance Circular 2008/04: *Certificates of Compliance – FMA Act Agencies*.

6 The Indemnity Guidelines do not impose an absolute prohibition on agencies entering into indemnities without complying with the listed preconditions (see pp 9–10). However, under the Indemnity Guidelines, agencies that do not impose one or more of the preconditions must record the reasons for this in writing.

7 See also Management Advisory Board, MAB/MIAC Report No. 22, *Guidelines for Managing Risk in the Australian Public Service*, October 1996.

8 The Department of Finance and Deregulation advises that the availability of insurance may not be taken into account when considering the most probable expenditure for FMA Regulation 10A purposes.

9 It is expected that the delegation will be reissued following the introduction of FMA Reg 10A.

10 There is a comprehensive discussion of this topic in a speech given by then Deputy Auditor-General, Ian McPhee, to the National Institute for Governance on 16 October 2002, entitled 'Risk Management and Governance'. The speech can be accessed on the ANAO website.

11 *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26 at [93] per Nettle J.

12 This *Liability Risk Assessment Guide for FMA Act Agencies* can be accessed at http://www.innovation.gov.au/Section/SmallBusiness/Documents/LiabilityRiskAssessmentGuide.doc

13 It is expected that this Finance circular will be updated following changes to the FMA Regulations that took effect 1 July 2010.

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