

LIABILITY RISK ASSESSMENT GUIDE FOR FMA ACT AGENCIES

INTRODUCTION

This guide to liability risk assessment for procurement by agencies under the *Financial Management and Accountability Act 1997* (FMA Act) has been designed to assist procurement officers in the liability stage of the risk assessment, and to help Commonwealth agencies to consistently treat risk and liability in Commonwealth contracts. While the principal aim of the guide is to assist in less complex procurement with small business, the issues are shared across all suppliers and are not specific to small business contracts.

It will assist procurement officers to understand the risks associated with a procurement and how they might be addressed through various mitigation strategies including the appropriate type and justifiable level (if any) of insurance to require of suppliers. Excessive risk transfer and insurance requirements increase the costs for the Government and suppliers. This guide is intended to assist in reducing costs for both, and reduce barriers to small businesses accessing the Commonwealth Government procurement market.

The guide consists of three elements:

- Part 1** A simple [risk assessment guide](#) to assist procurement officers through the liability risk assessment process for a procurement, to correctly allocate liability, assess any proposal from a supplier to limit liability and to arrive at justifiable levels of insurance to require of suppliers;
- Part 2** [Case studies](#) to assist in showing procurement officers how issues may arise in different contracting situations and how they may be handled to correctly allocate liability and set justifiable levels of insurance; and
- Part 3** [Model liability clause](#) that sets out an explanation of what the supplier will be liable for under the contract and reflect the allocation of liability.

The Commonwealth Procurement Guidelines (CPGs) provide direction to Commonwealth agencies on the process for purchasing goods and services (procurement). The CPGs state the general principle that risks should be allocated to the party best placed to manage them. Where an agency is best placed to manage a particular risk it should not seek to inappropriately transfer that risk to a supplier and similarly, agencies should generally not accept financial liability for risk which another party is better placed to manage.

Some FMA Act agencies may seek to transfer risk to suppliers, without properly assessing which party is in the best position to manage that risk. This can lead to requests for levels of professional indemnity and liability insurance that is considered higher than industry standard, is cost inhibitive and difficult to obtain for business.

A risk assessment should be undertaken at the start of a procurement process, prior to a Request for Tender (RFT) being issued.

The tools within this guide are designed to assist agencies and may be customised to suit individual agency requirements or used to supplement existing risk assessment tools. The case studies and templates used in this guide should be adapted to reflect the context of the operations of the applicable agency.

By following this guide, and undertaking appropriate risk assessment to justify the level (if any) of insurance required, contract negotiations may be easier further down the track.

How suppliers can use this guide

While this guide has been developed for use by procurement officers within FMA Act agencies, suppliers (particularly small business suppliers) can also benefit from gaining an understanding of its existence and contents.

When negotiating procurement contracts with FMA Act agencies, the benefits for business include:

- a better understanding of the management and allocation of liability risk within Commonwealth contracts; and
- the ability to ask questions of procurement officers and point to the model clause and case studies within the guide if they feel they are being asked to assume unjustifiable levels of risk and insurance.

PART 1 — LIABILITY RISK ASSESSMENT GUIDE

Purpose

The purpose of this section of the Guide is to assist procurement officers and other officials to undertake risk assessments, focusing specifically on liability risk. It should be used in conjunction with the other parts of the guide: the case studies (Part 2) and the model liability clause (Part 3).

A procurement officer will be familiar with undertaking a project risk assessment, which identifies and analyses the risks to be managed in the conduct of the project, including schedule risk, resourcing risks etc. However, when it comes to drawing up the procurement documentation, a risk assessment must be undertaken to identify and analyse the risk of liability that the Commonwealth may be exposed to by undertaking the procurement.

Procurement officers have an important role to play in undertaking this liability risk assessment. The liability risk assessment specifically considers the allocation of liability that may arise during the relationship between the parties, both throughout and after the contract period. This risk assessment can be used to identify the terms and conditions to be used in the contract to allocate liability between the parties and to mitigate any identified risks (e.g. through insurance, reporting or other mechanisms).

While the risk assessment should be completed pre-process to identify the potential liability risk prior to contract negotiations, the guide is also useful during negotiations, where contract amendments are requested, when new risks are identified or a supplier proposes to limit its liability, to help determine if those amendments are acceptable. As such, the risk assessment should remain a 'live' document and be updated as necessary.

Importantly, the risk assessment can be used to understand the potential for the Commonwealth to incur liability and the likely amount of that liability. That can assist procurement officers to put in place appropriate risk management arrangements and to understand the type and amount of insurance that may be required for the procurement.

This guide should be read in conjunction with existing policy guidance on indemnities and risk management, such as the *Commonwealth Procurement Guidelines* (CPGs) or the *Guidelines for Issuing and Managing, Indemnities, Guarantees, Warranties and Letters of Comfort* (the Indemnities Guidelines). It is not intended to replace the CPGs, the Indemnities Guidelines, and agency-level guidance on this issue.

Risk Assessment in Procurement

The liability risk assessment can be used to inform decisions such as:

- whether to proceed with the transaction; some transactions may present a risk profile that is not acceptable to the Commonwealth, making it necessary to rethink how to satisfy the identified requirement;
- whether the Commonwealth requires additional insurance or whether it should require specific types or amounts of insurance for the supplier;
- what clauses to include in the draft contract for the procurement;
- what information to seek from potential suppliers regarding risk to assist in choosing between suppliers;
- acceptable negotiation points;
- how to assess requests to amend the draft contract.

Therefore it is important to undertake the liability risk assessment early in the procurement cycle and then to update it as further information comes to hand.

Stage 1: Select the process

The selection of the process for choosing a supplier is made having regard to:

- the FMA Act and related Regulations;
- the Financial Management and Accountability (Finance Minister to Chief Executives) Delegation 2009;
- the CPGs ;
- Commonwealth policy regarding coordinated procurement;
- the Indemnities Guidelines;
- the likely value of the procurement;
- the nature of the relevant market for suppliers; and
- the timeframe needed both to understand the requirement and to deliver it.

For example if the value of the procurement exceeds \$80,000, the Mandatory Procurement Procedures in the CPGs are likely to apply. If the nature of the market is such that there are a large number of potential suppliers, a two stage process to allow short listing before suppliers have to invest a lot of money in tendering may be warranted. The risk assessment process is an important first step because it will identify key risks in the transaction and enable the process for selecting a supplier to be planned so as to mitigate these risks as far as possible.

Throughout part 1 of this guide we will refer to a case study to illustrate how the process works in practice. The case study relates to the fit out of newly leased premises for the Department of Film and Television (the Department).

Box 1: Case Study

The Department has identified the premises it wants to move to and has negotiated a lease with the owner. It needs to have the fit out of the premises completed to coincide with the end of its lease in its existing premises and to allow for an orderly move to the new premises.

From its knowledge of the market the Department estimates that the fit out is likely to cost \$5 million to \$5.5 million and that there are a number of potential suppliers who could undertake the task, and decides to conduct a tender process to select the contractor. Working back from the date when the Department requires the work to be completed, a plan is drawn up for a one stage open tender process to take 3 months in total from release of the RFT to execution of the contract, with 6 months for the fit out work and one month contingency before the planned move.

A two stage process comprising an EOI followed by an RFT was considered but rejected by the Department on the following grounds:

- it would be difficult to determine meaningful criteria to shortlist tenderers at an EOI stage without asking for significant work on costings for the project, thus the savings to tenderers from a two stage process were not significant enough to warrant it;
- the timeframe for the work meant that it was better to have a shorter process with more time for the actual work to occur.

In most cases the process for Government procurement will be competitive, from seeking a number of supplier quotes up to a full tender process comprising a number of stages.

Stage 2: Identify and prepare the documentation

Step 1: Identify what documentation is needed¹

Having determined the process by which the supplier will be selected, the next step is to prepare documentation for that process. In many cases, departments have template tender and contract documents that can be used for procurement. There are also Commonwealth templates, such as the common form tender documents issued by the Attorney-General under the *Legal Services Directions 2005* for use by agencies when procuring legal services. These templates represent the Commonwealth's preferred starting point for the majority of transactions, yet in some areas they require tailoring for the specific transaction or the insertion of information specific to the transaction.

¹ In this section we refer to the preparation of an appropriate contract. The assumption is that the supplier is being selected for a stand alone contract and is not being selected from a previously established panel. Panel arrangements usually have mandated contract forms already in place.

The first step is to identify what documents are needed and whether suitable templates exist for those documents. Where a suitable template does not exist, a department may require legal assistance to prepare the documents required for the transaction.

Box 2: Case Study

The Department determines that it needs the following documents:

- Conditions of Tender;
- a draft statement of work describing the Department's requirement;
- a draft Contract; and
- an evaluation plan

The Department has template documents for all of these but each requires tailoring. The Conditions of Tender template requires tailoring in the area of the evaluation criteria to apply. The template statement of work is nothing more than headings and will require significant work to prepare. The draft contract requires that schedules be completed with the Department's requirements for insurance included. The evaluation plan needs to reflect the evaluation criteria in the Conditions of Tender and explain how each will be evaluated. It also needs to identify the evaluation team and the timetable for evaluation.

Step 2: Prepare the document based on the initial liability risk assessment

The risk assessment assists procurement officers to produce transaction-specific documents from templates. In cases where templates do not exist, the risk assessment can assist by indicating the key risks to be addressed by the documents.

Conduct the liability risk assessment

The liability risk assessment should be undertaken in the context of the particular transaction being conducted. Therefore the first step is to consider the criteria by which risks will be assessed and to tailor that criteria to the context of the particular transaction. Risk criteria is a measure for the likelihood and consequences of risk events and is used in assessing those risks.

Decide the criteria to be applied

Likelihood and consequences can be expressed in either qualitative or quantitative terms or both. The key is to have comparative descriptions by which to assess each event².

² Some departments already have developed risk documentation that includes likelihood and consequence tables along with criteria for identifying risk. This guide does not override departmental specific policies.

First, the standards against which likelihood of specific occurrences will be judged should be determined. For example:

Table 1.1

Likelihood Ratings		
Rating	Qualitative Description	Quantitative Description
<i>Almost certain</i>	Expected to occur in most circumstances.	> 80 % probability
<i>Likely</i>	Will probably occur in most circumstances.	40 - 80 % probability
<i>Possible</i>	Could occur at some time.	20 - 40 % probability
<i>Unlikely</i>	Not expected to occur.	10 - 20 % probability
<i>Rare</i>	Will probably occur in exceptional circumstances only.	< 10 % probability

Note that the table is an example only, and the descriptors to be used should reflect the context of the particular transaction. Also note that when assessing particular risks that give rise to a contingent liability for the Commonwealth it will be necessary to assess likelihood with precision and in quantitative rather than qualitative terms. For example, it will be necessary to know whether the likelihood of a Commonwealth contingent liability occurring is less than 5% if approval under FMA Regulation 10 is required and the Department wishes to exercise the FMA Regulation 10 Delegation rather than seek approval from the Minister for Finance.

Second, the standards by which consequences will be judged should be decided. A liability risk assessment assesses the potential for the Commonwealth to incur liability. The key consequence of incurring liability is the cost. There may be other consequences, such as schedule delays or performance issues but the key issue for the contract will be to determine which party bears the cost of these consequences. Therefore, the simplest way to conduct a liability risk assessment is to analyse the cost consequences of the risk events.

Table 1.2

Consequence Ratings for Risks when allocating Liability		
Rating	Qualitative Description	Quantitative Description
Severe	Would cause significant financial loss.	Would cause the total actual contract costs, taking into account liabilities incurred by the Commonwealth, to exceed currently approved cost provisions by > 10%.
Major	Would cause major financial loss.	Would cause the total actual contract costs, taking into account liabilities incurred by the Commonwealth, to exceed currently approved cost provisions by 5-10%.
Moderate	Would have a moderate effect causing high financial loss.	Would cause the total actual contract costs, taking into account liabilities incurred by the Commonwealth, to exceed currently approved cost provisions by 2% to 5%.
Minor	Would have a minor effect causing medium financial loss.	Would cause the total actual contract costs, taking into account liabilities incurred by the Commonwealth, to exceed currently approved cost provisions by up to 2%.
Insignificant	Would have an insignificant or low effect causing low financial loss.	Would cause contract contingency funds to be used but total actual contract costs would not exceed currently programmed or approved cost provisions.

Again, note that the table is an example only and the descriptors used should be tailored to reflect the context of the particular transaction. For example, in some cases exceeding cost by 10% may not be of any significance in the context of the transaction and may be within the allowed contingency for the transaction. Also note that when assessing particular risks that give rise to a contingent liability for the Commonwealth it will be necessary to assess consequence with precision and in quantitative rather than qualitative terms. For example, it will be necessary to know whether the consequence of a Commonwealth contingent liability occurring is material if approval under FMA Regulation 10 is required and the Department wishes to exercise the FMA Regulation 10 Delegation rather than seek approval from the Minister for Finance. In some Departments, what is considered material is defined by reference to specific dollar amounts.

Finally, the description of risk taking into account assessed likelihood and consequence ratings should be decided. The following matrix is used in many departmental risk manuals.

Table 1.3

Standard Risk Management Matrix					
Likelihood	Consequence				
	Insignificant	Minor	Moderate	Major	Severe
Almost Certain	Medium	Medium	High	High	Extreme
Likely	Medium	Medium	Medium	High	Extreme
Possible	Low	Medium	Medium	High	High
Unlikely	Low	Low	Medium	Medium	High
Rare	Low	Low	Low	Medium	Medium

Identify the risks

Having established the standards by which risks will be assessed, the next step is to identify the liability risks for the procurement. This may involve a brainstorming session with the key stakeholders for the procurement.

When the Commonwealth enters into a contract to procure goods or services, it is exposed to liability in the following ways:

- common law - negligence, law of contract in relation to breach, damages, right to terminate;
- contract - express terms of the contract that allocate liability in a specific way (often different to what would occur under the common law) e.g. limitation on liability, indemnity; and
- statutory - imposition of limitations on liability through legislation, obligations under legislation that give rise to liability if breached.

All these sources of liability should be considered to identify the risks that may be relevant to the particular procurement. In particular, if the procurement is likely to involve a professional services provider such as an accountant, professional standards legislation may apply to limit the service provider's liability to the Commonwealth regardless of what is stated in the contract. A limit on liability imposed by legislation must also be taken into account in the liability risk assessment.

In most procurements the risks that should be considered are:

Risks
1. Risk that the procurement won't meet the required timeframe, exposing the Commonwealth to extra expense in continuing existing arrangements, making alternative arrangements and in flow on effects
- The contractor fails to complete the contract, i.e. the contractor goes into liquidation.
- The contractor delivers but the supplies or services provided under the contract do not work or do not provide the capability contracted for and so cannot be accepted.
- The contractor completes but not on time.
2. Risk that the actions of the contractor will result in a third party claim against the Commonwealth for injury, loss or damage suffered by the third party
- The contractor injures or kills people in the course of performing the contract.
- The contractor damages third party property (tangible or intangible).
- The contractor causes a third party to suffer economic loss in the course of performing the contract.
- Defects in supplies (after acceptance) result in people being injured or killed or damage to property.
- A third party claims against the Commonwealth for infringement of intellectual property rights as a result of the Commonwealth's use of the supplies.
- A third party claims against the Commonwealth for breach of confidentiality arising out of the Commonwealth's use of information supplied under the contract.
3. Risk that the contractor's actions result in Commonwealth loss or damage
- The contractor damages Commonwealth property while performing the contract
- Defects in supplies damage Commonwealth property or cause the Commonwealth extra expense or loss of productivity.
4. Risk that the Commonwealth fails to meet its obligations giving rise to Commonwealth liability to the Contractor
- The contractor claims against the Commonwealth for breach of contract, breach of warranty or under an indemnity that the Commonwealth has given to the contractor.

These are descriptions of events that could occur during performance of the contract for the procurement. In most cases the common law will allocate liability for these events to one of the parties to the contract, but in some cases that allocation may not be clear without obtaining a court decision. It is therefore advisable that the contract set out the parties' agreement as to how such liability should be allocated and most template contracts do just that. The model liability clause (part 3 of the Guide) provides an example of how liability can be allocated between the parties to a contract in a manner that will suit most simple procurements.

The risk assessment helps the procurement officer for a particular procurement to understand the Commonwealth's potential exposure as a result of these common risk events. This enables the procurement officer to tailor the contract to suit the identified risks and to take other action necessary to ensure risks are appropriately managed. For example, a key provision in any procurement contract is the requirement that the contractor have insurance. By understanding the risks associated with the procurement through the liability risk assessment process, the procurement officer will be able to specify appropriate types and amounts of insurance. The procurement officer will also be able to appropriately assess any request from a potential contractor to alter the types and amounts of insurance required. Further, by understanding the proposed allocation of liability for these events under competing proposals, the relative value for money can be assessed.

Consider how the potential impact of the risks will be affected by the terms of the contract

This will involve an analysis of the particular procurement being undertaken and an analysis of the terms of the contract being used and any specific drafting that may be included in the contract to address particular identified risks. The following table gives examples of how the identified risks above may be dealt with by typical contract clauses that are found in template contracts. In the event that the draft contract being considered does not include treatment for the identified risks, or there is a proposal to amend the contract to remove or limit the treatment of the risks, the risk assessment will help to identify the potential resulting risk that the Commonwealth will incur liability.

Risks	Typical Contract Treatment
1. Risk that the procurement won't meet the required timeframe, exposing the Commonwealth to extra expense in continuing existing arrangements, making alternative arrangements and in flow on effects	
<ul style="list-style-type: none"> - The contractor fails to complete the contract, i.e. the contractor goes into liquidation. 	<p>An ability for the Commonwealth to terminate and seek damages if the contractor suffers external administration or undertakes other activities that are a pre-cursor to liquidation.</p> <p>A financial security from the contractor to secure performance.</p> <p>A payment structure that provides for payment in arrears of performance.</p>
<ul style="list-style-type: none"> - The contractor delivers but the supplies or services provided under the contract do not work or do not provide the capability contracted for and so cannot be accepted. 	<p>Inclusion of an acceptance procedure and a process by which the Commonwealth can refuse to accept and refuse to pay for supplies that do not meet requirements.</p> <p>A financial security from the contractor to secure performance.</p>

	A payment structure that provides for payment in arrears of performance.
- The contractor completes but not on time.	<p>Inclusion of remedies for late delivery such as liquidated damages where the Commonwealth would suffer loss as a result of late delivery. NB: The term "liquidated damages" refers to an amount of compensation that the parties agree in the contract will be paid in the event of a specific default such as a failure to deliver goods on time. The agreed amount must be a genuine estimate of the loss likely to be suffered as a result of the default.</p> <p>A link between performance and payment so that payment does not occur unless performance is in accordance with requirements.</p>
2. Risk that the actions of the contractor will result in a third party claim against the Commonwealth for injury, loss or damage suffered by the third party	
- The contractor injures or kills people in the course of performing the contract.	An indemnity from the contractor to compensate the Commonwealth for liability to third parties.
- The contractor damages third party property (tangible or intangible).	An indemnity from the contractor to compensate the Commonwealth for liability to third parties.
- The contractor causes a third party to suffer economic loss in the course of performing the contract.	An indemnity from the contractor to compensate the Commonwealth for liability to third parties.
- Defects in supplies (after acceptance) result in people being injured or killed or damage to property.	An indemnity from the contractor to compensate the Commonwealth for liability to third parties.
- A third party claims against the Commonwealth for infringement of intellectual property rights as a result of the Commonwealth's use of the supplies.	A warranty from the contractor that the necessary IP rights have been supplied or an indemnity from the contractor to compensate the Commonwealth for liability to third parties for infringement.
- A third party claims against the Commonwealth for breach of confidentiality arising out of the Commonwealth's use of information supplied under the contract or the contractor's misuse of Commonwealth supplied information.	<p>Obligations on the contractor to observe confidentiality of material supplied by the Commonwealth.</p> <p>Obligations on the contractor to identify where there are confidentiality obligations to third parties when supplying information to the Commonwealth.</p> <p>An indemnity from the contractor to compensate the Commonwealth for liability to third parties where the breach was the result of the contractor's breach.</p>

3. Risk that the contractor's actions result in Commonwealth loss or damage	
- The contractor damages Commonwealth property while performing the contract	An indemnity from the contractor in respect of damage caused by the contractor.
- Defects in supplies damage Commonwealth property or cause the Commonwealth extra expense or loss of productivity.	<p>An indemnity from the contractor in respect of damage arising from the contractor's performance of the contract.</p> <p>In some cases there may be a financial security for performance.</p> <p>Remedies for breach of contract and product liability.</p> <p>Contractual warranties providing for repair of defective supplies.</p>
4. Risk that the Commonwealth fails to meet its obligations, or an event arises for which the Commonwealth has indemnified the Contractor, giving rise to Commonwealth liability to the Contractor	
- The contractor claims against the Commonwealth for breach of contract, breach of warranty or under an indemnity that the Commonwealth has given to the Contractor.	<p>Remedies for breach of contract. Usually the Commonwealth's primary obligation relates to payment so the Commonwealth is unlikely to be in breach.</p> <p>Where the Commonwealth has given a warranty or indemnity, the approval process is dictated by Commonwealth policy.</p>

Insurance

Insurance is not a treatment of risk in itself but it is important as it may provide a financial resource for meeting liability that arises from the risk. Commonwealth Departments have insurance coverage through Comcover for a range of liability risks. Suppliers will also usually have insurance coverage that relates to common risks arising from the conduct of their business. It is important for the Commonwealth to understand the insurance coverage available to the contractor because insurance may provide the contractor with resources to meet its potential liability to the Commonwealth or a third party. In other words the existence of insurance provides some comfort that the Commonwealth will be paid under a contractor indemnity or in other cases of contractor default. But to understand what level of comfort can be gained from the existence of insurance a procurement officer needs to understand how insurance works.

It is important to note that a contractor's insurance usually does not mean that the Commonwealth is insured³. Insurance merely means that the contractor may be able to call on insurance in the event the contractor becomes liable to the Commonwealth. Unless the Commonwealth has express rights in the policy to claim on the contractor's policy⁴, the Commonwealth will have no right to claim the amount owed by the contractor directly from the contractor's insurer.

Insurance is particularly important if the contractor would not be able to satisfy a liability in the absence of insurance. Without insurance the contractor may be driven bankrupt or insolvent and the Commonwealth may be left with no recourse for the liability.

What types of insurance are there and what do they cover?

The main types of insurance usually dealt with in Government contracts are:

- public liability insurance, which generally covers liability for death or injury, loss of or damage to property, or economic loss;
- professional indemnity insurance which generally covers a breach of professional duty of care liability as a result of negligence in providing services (certain industries will have standard professional indemnity insurance policies);
- works insurance which generally covers works in the course of construction and any goods in a contractor/supplier's control;
- property in transit insurance any goods in transit in a contractor/supplier's control; and
- workers compensation insurance, which covers compensation to the insured's employees for workplace illness and injuries and is mandated by State and Territory law.

³ It is not insured under the contractor's insurance policy. The Department may have its own insurance under its Comcover policy.

⁴ For example by being named as an insured or through having a right of subrogation.

There are also specific insurance policies to cover particular activities such as marine insurance, hangar-keeper's insurance, aviation risk insurance etc. If you are dealing with a contract that relates to a specialised industry sector, it is worth obtaining specific advice concerning the types of available insurance and the standard coverage provided.

The coverage of each type of insurance depends on the wording of the policy. Individual policies will almost always include some form of exclusion or limitation. For example, there may be a deductible which is payable by the contractor for each claim such as the first \$1000 of any claim. Alternatively there may be obligations on the contractor with the result that the coverage is voided if the obligations are not met. These can include obligations of disclosure of claims or of company circumstances. Prudent agencies should request that a contractor provide evidence of insurance⁵ before the contractor commences work and should assess the likelihood that the contractor will be able to renew insurance if the policy is due to expire during the period of the contract. Where possible, for more complex procurements in which insurance is of particular importance, the agency may request to examine the contractor's insurance policy to ensure it covers what it should.

"Per claim" vs "aggregate" amounts

Insurance amounts can be either a per claim or an aggregate basis. A per claim basis policy means that the payout for each claim is capped at that amount, while an aggregate basis policy sets the maximum amount that is payable under a policy, regardless of how many claims occur. Many policies limit both the per claim and aggregate amount.

A contractor may have a number of clients, and thus a number of sources of potential liability, but only one insurance policy. Therefore, aggregate limits need to be carefully considered as they may mean the contractor's insurance is "used up" through claims by other parties.

"Claims made" vs "claims occurring"

Insurance policies can be on "claims made" or "claims occurring" basis. These terms determine the period of coverage. Under a "claims made" policy, the insured is covered for claims made during the period of coverage of the policy, even if the events that led to the claim occurred before the coverage commenced. A "claims occurring" policy means the insured is covered for claims that relate to events that occurred during the period of coverage, even if the claim itself came after the period of coverage ended. Often there is a requirement in a contract for a contractor to maintain insurance (sometimes referred to as 'runoff cover') for a period after the contract has ended if the insurance policy is on a "claims made" basis⁶. As part of the risk assessment process there should be a

⁵ Usually through a certificate of currency.

⁶ For example there may be a requirement to maintain insurance for seven years after the contract has ended as that period is consistent with the period within which a claim can be lodged with a court.

consideration of whether such 'runoff cover' is required and if so the length of time it should be in place.

What is a justifiable level of insurance to request of a contractor?

If it is determined that insurance is required for a contract, the next stage is to determine the appropriate or justifiable level of insurance to contractually require the contractor to maintain.

The levels of insurance required are going to differ between contracts and need to be assessed on a case-by-case basis. Default levels required through standard contracts (e.g. default of \$10 million public liability insurance) may not be justifiable or appropriate. Consideration of what level of insurance is appropriate needs to take into account:

- the potential likelihood and consequences of the Commonwealth incurring liability as a result of the contractor's activities;
- any limit on the Contractor's liability to the Commonwealth whether imposed by legislation, the contract or through the operation of the general law;
- what levels of insurance are available in the market place; and
- the cost of the premium for that insurance.

The risk assessment process is therefore an important element in assessing and justifying the required level of insurance. It is important to ensure insurance requirements do not exceed the value of the risks that might reasonably be expected to arise under a contract. The level of insurance required of a contractor should not simply default to an amount to mitigate the maximum cost of a potential loss if the likelihood of that risk eventuating is rare or unlikely. Similarly, it may not be appropriate for a subcontractor to be required to hold the same amount of insurance as the principal contractor, if the risks associated with each contract are different⁷. As the cost of the contractor's insurance adds to the cost of the procurement, a requirement for excessive insurance may not be a proper use of resources.

In this regard, care should also be taken to make certain that the insurance requirements under the contract do not exceed what is required to support the contractor's potential liability under the contract. Specialist insurance advice may be warranted to analyse the insurance products available in a particular industry or market.

⁷ Although the subcontract is not usually with the Commonwealth, the terms of the subcontract are often dictated through flowdown provisions in the contract between the Commonwealth and the principal contractor.

Box 3: Case Study

The Department considers the work it requires for the fit out and determines that the following types of insurance are relevant:

- workers compensation insurance to ensure that the contractor is able to compensate its own employees who might be injured on the Commonwealth's premises;
- public liability insurance to ensure that the contractor can compensate other people who might be injured or have their property damaged, including Commonwealth employees; and
- professional indemnity insurance to ensure the Commonwealth can be compensated if the contractor provides negligently incorrect design advice regarding the fit out and the Commonwealth suffers loss as a result.

The Department obtains specialist insurance advice on the availability of insurance and discovers that there is a standard public liability policy available in the construction industry that provides for \$5 million per claim up to an aggregate of \$30 million in any one year. For an additional premium this cover can be increased to \$10 million per claim up to an aggregate of \$30 million per year. Through the risk assessment process the Department determines that the site will be secured during the work and the only Commonwealth employee allowed on site will be the project manager who will be escorted at all times. There will be no access to members of the public. On the basis of the risk assessment, the Department determines that the standard policy provides adequate protection for the contract and the increased insurance is not required.

Assess risks using the identified standards

Having decided on the criteria to apply, the identified risks are then assessed on the basis of the likely consequences in the context of the particular procurement. It is important in this exercise to consider the consequences of the risk events taking into account the treatments provided for in the contract so that a realistic rather than a worst case scenario can be developed. Note that when assessing risks that give rise to Commonwealth contingent liabilities it is necessary to assess and quantify both the maximum amount that may become payable should the contingent liability arise as well as the most probable cost that may arise. This is because regard must be had to the maximum amount that may become payable in determining whether FMA Regulation 10 approval is required, but if such approval is required then regard must be had to the most probable cost in determining materiality. The maximum amount that may become payable should be calculated within the context of the risk treatments but should not take into account insurance that may be available.

The following is an example of a risk assessment in the context of the Case Study.

Risk	Causes	Treatment	Cost effectiveness	Likelihood	Consequence	Risk Level	Residual Risk Exposure
The contractor fails to complete the contract, i.e. the contractor goes into liquidation.	<ul style="list-style-type: none"> -Financial viability of the company -Inadequate cash flow to support ongoing performance 	<ul style="list-style-type: none"> -Evaluation criteria in the tender should examine financial viability. -Requirement in tender for tenderers to submit information regarding financial viability. -Payment regime provides for payment in arrears thus reducing the risk of loss. -Contract clauses to allow for termination and damages. -Consider requiring a financial security. 	Treatments are commercially standard and should not impact tendered price except in the case of the financial security and that will depend on amount. Consider whether financial securities are normal business practice in this industry.	Rare. It is estimated that there is a less than 10% chance this will occur, given the emphasis in selection and that the work will be completed within 6-7 months. This assessment will be updated based on the bids received.	Moderate. Given the short period for contract performance it is likely that an alternative supplier could be found quickly for little additional cost. At this stage assuming a financial security will not be obtained.	Low	\$220,000, assuming a financial security will not be obtained. There is no insurance applicable to this risk.
The contractor delivers but the supplies provided under the contract do not meet the requirement.	<ul style="list-style-type: none"> -Lack of expertise in the Company. -Degree of difficulty in the requirement. 	<ul style="list-style-type: none"> -Ensure the requirement is achievable and can be built using standard materials. -Evaluation criteria should address experience of the bidders in building similar requirements. -Contract requires Commonwealth sign off on design work before building commences. -Contract clauses to require adherence to standards and inspections of workmanship prior to acceptance. -contract clauses to link payment to acceptance. -Inclusion of liquidated damages for 	The magnitude of required liquidated damages clause will probably impact tendered prices.	Unlikely. Even with the focus on selecting an experienced contractor it is estimated that there is a 10% chance of substandard work given some of the unique features of the building.	Severe. Any delay that exceeds the contingency period means that the lease on the existing building must be extended. This cannot occur for less than a 6 month period at a cost of \$3m.	High	Liquidated Damages will apply to any delay after contingency period expires. Some residual exposure of \$100,000.

Risk	Causes	Treatment	Cost effectiveness	Likelihood	Consequence	Risk Level	Residual Risk Exposure
		instances where delay would cause Commonwealth extra expense.					
The contractor completes but not on time.	Delays in obtaining materials, unforeseen issues requiring design changes, rate of progress in performing the work and need for re-work.	-Evaluate the proposed timetable to ensure it is achievable. Consider building in more time or undertaking efficiencies. -Link payment to milestones on a critical path to create an incentive for timeliness - inclusion of liquidated damages for instances where delay would cause Commonwealth extra expense	The magnitude of required liquidated damages clause will probably impact tendered prices.	Possible. Chance of a delay is estimated to be 20%.	Severe. Any delay that exceeds the contingency period means that the lease on the existing building must be extended. This cannot occur for less than a 6 month period at a cost of \$3m.	High	Liquidated Damages will apply to any delay after contingency period expires. Some residual exposure of \$100,000.
The contractor injures or kills people in the course of performing the contract.	Unsafe work practices.	-Include in the contract an indemnity from the contractor in respect of third party personal injury. -Do not allow a limitation on liability in respect of the indemnity. -Require the contractor to have insurance for public liability and professional negligence. -Require the contractor to be appropriately licensed and observe OH&S requirements -Undertake monitoring of practices and insurance during the contract.	Liability under the indemnity may affect price but depends on contractor's assessment of risk and their level of insurance. The other requirements are commercial standards and should not attract a price premium.	Unlikely. Estimated 10% chance of occurring because access to the site will be restricted.	Major. Estimated cost of injury would be around 8%.	Medium	Exposure limited to actions where it cannot be proven that the contractor was negligent or cannot recover from the contractor. Consider likely magnitude of claims and ensure that insurance levels are adequate.
The contractor damages third party property.	The building is owned by a third party and leased to the Commonwealth. The Commonwealth indemnifies the owner in respect of its contractors.	-Include in the contract an indemnity from the contractor in respect of third party property damage. -Require the contractor to have insurance for public liability and professional negligence. -Undertake monitoring of practices and insurance during the contract.	Liability under the indemnity may affect price but depends on contractor's assessment of risk and their level of insurance.	Possible. Estimated chance of damage to the building occurring is 30%.	Severe. Worst case scenario is \$5m damage.	High	Exposure limited to actions where it cannot be proven that contractor was negligent or cannot recover from the contractor. Consider likely magnitude of claims and ensure that insurance levels are adequate.
Defects in the work result in people being injured or damage to property	Design or workmanship defects result in hazards.	-Include warranties in the contract to allow for rectification of hazards. -Indemnity in the contract in respect of third party injury or property damage.	-Cost of warranty will depend on contractor's assessment of likely incidence of remedial work.	Possible. Estimated chance of requirement for remedial work is 30%.	Moderate. Unlikely to exceed 5%.	Medium	Exposure limited to actions where it cannot be proven that contractor was negligent or cannot

Risk	Causes	Treatment	Cost effectiveness	Likelihood	Consequence	Risk Level	Residual Risk Exposure
			-Liability under the indemnity may affect price but depends on contractor's assessment of risk and their level of insurance.				recover from the contractor. Consider likely magnitude of claims and ensure that insurance levels are adequate.
A third party claims against the Commonwealth for infringement of IP rights.	Use of IP without permission.	-Include an indemnity in respect of IP infringement.	-Liability under the indemnity may affect price but depends on contractor's assessment of risk.	Unlikely. Would expect the contractor to adequately manage the risk and assess IP rights before use.	Minor. extra cost unlikely to exceed 2%.	Low	Liability will be covered by the indemnity. Exposure limited to minor costs.
A third party claims against the Commonwealth for breach of confidentiality.	Not applicable - no confidential information will be supplied.						
The contractor damages Commonwealth property while performing the contract.	Not applicable - the contractor will not have access to any Commonwealth property.						
Defects in the work damage Commonwealth property or cause the Commonwealth extra expense or loss of productivity.	Design or workmanship defects result in hazards that damage other Commonwealth property after the Department moves into the building.	-Include an indemnity in respect of damage to Commonwealth property. -Include a warranty to allow for rectification of hazards. -Investigate whether contractor has professional indemnity insurance and whether this risk would be covered.	-Cost of warranty will depend on contractor's assessment of likely incidence of remedial work. -Liability under the indemnity may affect price but depends on contractor's assessment of risk and their level of insurance.	Possible. Estimated chance of requirement for remedial work is 30%.	Minor. extra cost unlikely to exceed 2%.	Medium	Liability will be covered by the indemnity. Exposure limited to minor costs.
The contractor claims against the Commonwealth for breach of contract.	Obligations on the Commonwealth are for timely turnaround of design approvals and for payment.	Commonwealth will put in place a project manager to manage all aspects of the contract and ensure the Commonwealth performs its obligations on time.	Cost of project administration is factored into overall budget. Requirements will be adequately resourced.	Rare	Minor	Low	Negligible cost exposure.
The contractor claims against the Commonwealth	Commonwealth personnel damage contractor property	Commonwealth personnel appropriately trained and subject to code of conduct.	Commonwealth unable to obtain goods and services required	Rare. Because this is a Commonwealth contingent liability	Minor. Because this is a Commonwealth contingent liability	Low	\$50,000.

Risk	Causes	Treatment	Cost effectiveness	Likelihood	Consequence	Risk Level	Residual Risk Exposure
under an indemnity in respect of damage to Contractor property as a result of the acts or omissions of Commonwealth personnel	during visits to contractor premises		without provision of the indemnity.	assessment should include precise quantification to assist with necessary approvals. In this case assessment puts likelihood at 2%.	assessment should include precise quantification to assist with necessary approvals. In this case assessment of consequence is \$50,000 (maximum amount payable). This is total value of property at risk and is less than 2% of the contract value. Most probable cost is assessed at \$10,000.		

Stage 3 - Update the risk assessment throughout the procurement cycle

If conducting a tender process each bidder will indicate either an acceptance of or modifications to the liability regime that was proposed in the draft contract. The risk assessment can be updated for each bidder to assist in the comparison of the risk of competing bids.

If negotiations are proceeding with one potential contractor then the risk assessment can be used to determine what areas of the contract may be negotiated.

Also, it is important to update the risk assessment as new information comes to hand that may affect the risk assessment.

PART 2 — CASE STUDIES

The following case studies are designed to illustrate how liability and insurance issues may arise in procurement processes and be resolved using the liability risk assessment process.

1. A simple procurement of goods (value approx \$30,000)
2. A more complex procurement with greater risk exposure
3. Consultancy involving professional standards legislation limitation of liability
4. A venue hire contract
5. A simple consultancy contract
6. A contract for the provision of financial advice

A SIMPLE PROCUREMENT OF GOODS (VALUE APPROX \$30,000)

The Commonwealth Department of Film and Television (Department) has decided to commission a sculpture to be created and installed in the foyer of the building.

Through the conduct of a tender process, Mr Michael Angelo is selected to create and install the sculpture.

Mr Angelo asks the Department if he can be paid the amount for the sculpture (\$30,000) upfront in order to procure the materials he needs. The Department is concerned about this. A number of years ago, they commissioned an artwork from a Mr Leonard Odavinci for the foyer of their previous building. Mr Odavinci was paid \$20,000 upfront and promptly flew to the Cayman Islands. The sculpture was never completed and the money could not be recovered.

However, Mr Angelo insists he cannot commence the work without payment upfront. The Department considers its options as follows:

- Option 1: requiring a form of security (such as a bank guarantee or a third party guarantee) from Mr Angelo to secure the repayment of the \$30,000 in the event the sculpture was not delivered;
- Option 2: structuring the contract so that the Department purchases the materials on Mr Angelo's behalf; or
- Option 3: making progress payments to Mr Angelo for supplies as they are obtained with ownership of the supplies passing to the Department on payment.

Complete a Risk Assessment

The Department conducts a risk assessment, which reveals that:

- Option 1 is likely to cost the Department more money because Mr Angelo would seek to pass the cost of the security to the Department;
- Option 2 would still result in a loss to the Department if Mr Angelo failed to complete the sculpture, although it would be a smaller loss than \$30,000; and
- Option 3 would mean that, if Mr Angelo failed to complete the sculpture, the materials could be provided to a replacement artist or resold to recoup funds. There may still be some loss to the Department as a result of the cost of having to find a replacement artist.

On the basis of its risk assessment, the Department decides that it can live with some element of risk rather than not proceed with the project, and chooses Option 3. The Department discusses with Mr Angelo the actual amount he will need to commence, and the actual amounts he will need at later stages (such as installation). On the basis of this discussion, the Department agrees to pay Mr Angelo in the following instalments.

- The first instalment (approximately 40%) is to be paid on execution of the contract on the basis of invoices from the materials suppliers with ownership of the materials passing to the Department;
- the second instalment (approximately 30%) will be paid in respect of Mr Angelo's labour costs when the sculpture is complete and ready to be installed, and
- the final instalment (approximately 30%) will be paid after successful installation.

Title to the sculpture will pass to the Department on its completion and before installation but the risk of damage to the sculpture will remain with Mr Angelo until installation is completed. The Department considers that, while there is some risk with the initial payment, there is an incentive for Mr Angelo to complete the work.

Insurance Requirements

Mr Angelo is happy with the instalment payments but has some concern over the required insurance when he is first provided with the contract for consideration. He has \$2 million public liability insurance; however, the Department's standard form contract requires that he have a policy for \$10 million. Mr Angelo had factored in an amount to pay for the extra insurance but when he speaks to an insurance broker, he discovers that such a policy is not available without agreeing to a much larger deductible, which Mr Angelo cannot afford.

On the basis of its risk assessment, the Department considers that the most likely risks are non-delivery and damage to the building during installation. The Commonwealth's potential liability as a result of a failure to deliver has been significantly mitigated through the agreed payment and title transfer arrangements. Considering what is in the vicinity of the installation space and the measures to be taken to prevent public access during installation work, the Department has assessed that the likely damage to the building would not exceed \$200,000 and the risk of injury to third parties is very low. It is the risk of damage to the building or injury to others that would be covered by the public liability insurance. The Department thus agrees to the lower insurance amount of \$2 million as that will be sufficient to cover the assessed risk.

Under the Department's lease with the building owner, the Department must indemnify the building owner for all damage caused to the building. The Department included a specific indemnity in the contract with Mr Angelo providing that Mr Angelo indemnify the Department against all its losses or costs arising from damage to the building. Mr Angelo had requested that this indemnity be capped at the amount his insurance would pay out. The Department refused this on the basis that it exposed the Department to the potential liability of its losses and costs if Mr Angelo's insurance company refused to pay out for any reason. The insurance could be rendered void by Mr Angelo's failure to disclose relevant information or failure to pay premiums when due.

The contract is signed, Mr Angelo is paid the initial instalment and he begins the sculpture. When completed in his warehouse, Department officials inspect it and see that it is looking good. They provide Mr Angelo with the second instalment.

In the course of installing the sculpture, Mr Angelo severely damages a wall in the building. The building owner assesses the damage to the building at \$300,000. This seems very high to the Department, and it challenges it through the expert determination process set up for such situation in its lease. The Department incurs \$5,000 in legal and other costs in doing this. The damage is eventually assessed at \$150,000 and the Department has to pay this to the building owner. The Department thus claims \$155,000 under the indemnity from Mr Angelo (being all the costs it has incurred in relation to the damage). Mr Angelo claims this amount from his insurer.

Summary of how the justifiable level of insurance was determined

HIGHEST RISK THAT COULD REASONABLY CRYSTALISE (as determined by full risk assessment)				
Risk/s that require mitigation	Likelihood & Risk Level	Consequence	Risk Exposure	Insurance level Required
Damage to building	Possible (30%)	Moderate	Maximum of \$200,000	Contractor has existing \$2m policy which is sufficient coverage.

Note: This case study refers to an example of a tender process where a standard form contract and standard insurance amount was used rather than the insurance amount being tailored at the outset based on a risk assessment. The example was used to illustrate the benefit of conducting the risk assessment prior to release of the tender. The Department may have received a better range of tenders had risk been appropriately allocated in the draft contract that went out with the tender.

A MORE COMPLEX PROCUREMENT WITH GREATER RISK EXPOSURE

The Department grows rapidly and needs to move into another building. It leases office space, but needs it to be fitted out to its requirements.

The Department releases a Request for Tender for provision of the fit out.

The Department has conducted a risk assessment and concluded that the risks it faces include:

- expense to undertake repairs if the fit out contractor damages the building;
- expense to find alternative accommodation or remain in the current accommodation if the fit out contractor is delayed in completion, and
- expense to rectify the finalised fit out if it is not fit for the Department's purposes.

As a result the Department structures the proposed contract so that:

- the contractor will indemnify the Department against any damage to the building, including any amount the Department has to pay to the owner of the building;
- the payment structure will be tied to milestones, and failure to meet milestones will result in payment of reduced amounts. This is achieved by providing for liquidated damages in the contract, that is, an amount of compensation to be paid to the Department in the event of delay which is based on an agreed estimate of the Department's likely loss as a result of the delay; and
- the Department must approve all design specifications and can periodically inspect the work.

The tender from Con Tractor and Sons Pty Ltd is for \$5 million. A tender from Second Place Pty Ltd is also very good, but it is slightly higher in price. Con Tractor requests its liability be limited to \$5 million, including the indemnity to the Department. Second Place does not. To assess value for money in this situation, it is necessary to complete a full risk assessment to determine whether the limitation of liability is likely to lead to additional costs being imposed upon the Department. The Department decides that it does not, determines that this tender is the best value overall for the total package and enters into negotiations with Con Tractor and Sons Pty Ltd to resolve outstanding issues.

Complete a Risk Assessment

The Department's risk assessment reveals that:

- the damage to the building that could be caused is difficult to quantify, but in the worst case could approach \$10 million;
- if the Department wanted to stay in its current accommodation for any longer than the current lease it would have to sign up to another 6 month lease at a cost of \$3 million. There are no options for alternative accommodation;

- given the presence of other tenants in the building there is a risk of claims against the Commonwealth for personal injury and property damage caused by the contractor. This risk could give rise to significant liability but it is difficult to quantify; and
- the scope of work involves an element of design work for the fit out. Although the Department will be approving the design before it is used to ensure the Department has adequate space, it will not have the expertise to identify any likely construction problems that may require a re-design.

On the basis of the risk assessment, the Department is not willing to limit the contractor's liability for personal injury or property damage suffered by third parties. Also, the Department considered that the contractor's liability for any damage to either the building or to third party property caused by the unlawful or malicious acts of the contractor's employees should not be limited. The Department also notes that the tender response for Con Tractor states that Con Tractor has a public liability insurance policy for \$10 million per claim and \$50 million in aggregate per year. This indicates that Con Tractor would have the resources to meet a claim for personal injury or property damage, including damage to the building up to \$10 million.

The Department enters into negotiations with Con Tractor on the basis that the Department will accept a limitation on Con Tractor's liability to \$5 million provided that the limitation will not apply to:

- liability to the Commonwealth in respect of damage to the building; and
- liability to the Commonwealth as a result of third party claims against the Commonwealth for personal injury or property damage.

The Department also requires that Con Tractor provide an indemnity to the Department for damage to the building caused by Con Tractor or its subcontractors in performing the work.

Con Tractor agrees to the modified limitation on liability and the contract is signed.

Con Tractor commences work. The Department monitors it from time to time to ensure it is still proceeding as planned. On a monitoring visit, the Department notices that one of the walls has been put in at an odd angle. It calls this to the attention of Con Tractor and notes the provisions in the contract relating to the quality of workmanship. These provisions require Con Tractor to fix such a defect at its own cost.

Con Tractor hires a subcontractor to fix the wall. In the course of repairing the wall, it collapses, damaging part of the building and some of the Department's equipment. The Department claims its expense in having the building repaired and replacing the equipment from Con Tractor under the indemnity.

Application of the liability cap

The Department notices that after Con Tractor incurs the additional costs in relation to the wall, the pace of work generally appears to slow. It seems Con Tractor is pursuing more profitable jobs and is not sending as many workers to the Department's site as are needed. This is raised at several project meetings but Con Tractor continues to assure the Department that the work will be completed on time. In fact, Con Tractor is late in completing the fit out. The Department has to enter into the lease extension on its existing building because of the delay, at a cost of \$3 million. Con Tractor is required to pay \$3 million in liquidated damages for the late completion, which is within the cap of liability for the contract.

Summary of how the justifiable level of insurance was determined

HIGHEST RISK THAT COULD REASONABLY CRYSTALISE (as determined by full risk assessment)				
Risk/s that require mitigation	Likelihood & Risk Level	Consequence	Risk Exposure	Insurance level Required
Damage to the building	Possible (30%)	Severe	Up to \$10m	At least \$10m per claim, with an aggregate to cover liability for third party claims from other tenants

CONSULTANCY INVOLVING PROFESSIONAL STANDARDS LEGISLATION LIMITATION OF LIABILITY

Introduction to Professional Standards Legislation

This Case Study explores a situation where the liability of the contractor is limited because of the application of Professional Standards Legislation. Professional Standards Legislation has been passed in each State and Territory in Australia. The legislation establishes a Professional Standards Council in each State and Territory. In fact, all States and Territories have agreed to appoint the same eleven members to their council and each council has the same secretariat.

The Council may approve a scheme proposed by a professional association to limit the occupational liability of the members of the association. Occupational liability is civil liability arising directly or vicariously from anything done or omitted by a member of an occupational association acting in the performance of his or her occupation. Liability arising from:

- the death of or personal injury to a person;
- a breach of trust; or
- fraud or dishonesty,

cannot be limited under the scheme. Further, there is a threshold amount in each Act under which liability cannot be limited.

All documents provided by the professional to clients or potential clients that advertise or promote the professional's occupation must notify that the scheme applies. The scheme applies by force of the legislation, rather than anything stated in the contract for the professional services. However, if the scheme is to apply to limit liability, the law applicable to determining that liability must be the law that applies the benefit of the scheme. In other words if the contract is to be interpreted under NSW law but it is Victorian law that applies to the scheme then the scheme will not be available in relation to a breach of the contract. The impact of this difference should lessen over time as more schemes are approved across all Australian jurisdictions.

Case Study

The Department needs to acquire some land to construct a grand multi-site museum for the Australian film industry. The museum is to be located in three places; Darwin, Sydney and Melbourne. The Department engages a surveyor, Ms Magoo to survey pieces of land in each location to assist in the planning of the museum.

Ms Magoo is covered by the Professional Surveyors Occupational Association Inc Scheme under the Professional Standards Act 1994 (NSW) which limits her liability for occupational liability. The scheme only applies in NSW, because the professional associations for surveyors have not yet sought to register schemes in other States.

Ms Magoo wants the law of the contract to be NSW law to ensure the scheme will apply to the contract to limit her liability.

Ms Magoo is also concerned that, even if the law of the contract is NSW law, there still may be situations in which the Department could sue her for negligence in Victoria or the Northern Territory because she will be performing the services in each of these locations on the museum sites.

Complete a Risk Assessment

The Department conducts a risk assessment, which reveals that:

- the scheme in NSW has the effect of limiting Ms Magoo's liability to the Department for loss caused by her professional services to \$5 million. Liability for personal injury or death or as a result of breach of trust, fraud or dishonesty is not limited;
- the Department's main risk arising from Ms Magoo's services results from incorrect survey data. This could lead to the Department incurring expense for things such as compensation to neighbouring land holders or the costs of re-design of buildings;
- expense arising from incorrect survey data could be up to \$10 million per site; and
- Ms Magoo's professional indemnity insurance is limited to \$5 million per claim based on an assumption that she will always have the benefit of the scheme or be able to negotiate a similar limitation of liability into her contracts.

Based on the risk assessment, the Department decides to enter into a separate contract with Ms Magoo for each site, with the law governing the contract to be the law of the State or Territory in which the site is located. Only the contract relating to the Sydney site will therefore be subject to the limitation of liability imposed by the statutory scheme. The Department puts in place additional safeguards for checking the survey data in relation to the Sydney site where the survey data is to be relied upon for building placement on the site in order to lessen the risk that it will incur expense in excess of the cap on liability. As part of good risk management practice, the Department and Ms Magoo agree it is in both parties' interests to have these additional safeguards in place in relation to the Darwin and Melbourne sites as well.

Insurance Requirements

Ms Magoo purchases additional insurance specifically for her work on the Darwin and Melbourne sites, where her liability is not limited under the scheme. Because she is able to demonstrate to her insurer the risk mitigation strategies she will have in place for that work and her low previous claims history, she is able to obtain a discounted premium.

Summary of how the justifiable level of insurance was determined

HIGHEST RISK THAT COULD REASONABLY CRYSTALISE (as determined by full risk assessment)				
Risk/s that require mitigation	Likelihood & Risk Level	Consequence	Risk Exposure	Insurance level Required
Incorrect Survey Data	Possible (30%)	Severe	Up to \$10m at each site, however liability is limited by the scheme in NSW to \$5m.	\$5m per claim for the Sydney contract and \$10m per claim for the Melbourne and Darwin contracts

VENUE HIRE CONTRACT

As part of the activities to celebrate the commencement of construction of the Sydney museum, the Department wants to hold a gala dinner for artists, curators, Members of Parliament and other distinguished guests.

The Department wishes to hire a function room at a hotel that overlooks the museum site for the dinner. The hotel presents the Department with its standard form hire agreement which includes an indemnity for any damage caused to the room or for any claim by a third party against the hotel for personal injury or property damage as a result of the function. The indemnity does not extend to damage or injury caused by the hotel or its staff.

The Department considers the requirements of Financial Management Guidance No. 6 Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort (September 2003) (FMG 6). Of particular importance in this transaction are the requirements that the benefits of giving the indemnity outweigh the risks and the consideration of the availability of insurance.

The Department considers whether its expected benefits outweigh the risks. The hotel will not allow use of the function room without the indemnity and the Department considers the dinner to be important to bolster support for the museum project and communicate the museum design to interested stakeholders. There is no venue that could be used for the dinner that does not involve a similar indemnity. The Department is in the best position to manage the particular risks of the indemnity as the Department will be in control of who is invited to the dinner and will be best placed to manage the behaviour of guests at the dinner. Noting that the indemnity does not extend to damage or injury caused by the hotel or its staff, the Department considers that the benefits to be gained by providing the indemnity and therefore going ahead with the dinner outweighs the risk of liability under the indemnity.

Complete a Risk Assessment

The Department conducts a risk assessment, which reveals that:

- the most significant liability would result if there was total destruction of the venue and injury to the majority of the guests, for example if there was a terrorist attack on the dinner. However, it is unlikely that the group at dinner would be considered a terrorist target;
- apart from total destruction, which would result in property damage to a value of \$1 million, the most likely event is minor damage in the amount of \$1,000; and
- given the number of guests and the nature of the occasion, damage through deliberate vandalism was considered unlikely.

The outcome of the risk assessment is that the indemnity could give rise to significant liability, although the chance of the liability occurring may be remote.

The Department also considers the availability of insurance.⁸ The Department approaches Comcover with appropriate documentation to request coverage of the indemnity.

In order for Comcover to consider the coverage of an indemnity they require:

- the relevant contract clauses;
- a risk management plan to manage the risk (this is developed from the risks and risk treatments identified in the risk assessment);
- legal advice on the potential impact of the indemnity (this is also required under FMG 6 as part of the approval process for the indemnity).

Comcover advises that the Department's existing insurance covers it for the indemnity to the extent that the indemnity reflects what the Department would be liable for under the general law. Clearly, the Department would be liable for the actions of its own staff in the course of their duties and it would not usually be liable for the behaviour of other guests. However, Comcover agrees to extend insurance coverage for the risks in the indemnity.

Having agreed the terms of the indemnity in principle, sought appropriate legal advice, and met the requirements of FMG 6 to the satisfaction of the Delegate under Regulation 9⁹ of the *Financial Management and Accountability Regulations 1997* (FMA Regulations), the Department seeks (and prior to the approval obtains) the appropriate authorisation under Regulation 10 of the FMA Regulations as the indemnity is a contingent liability that is not covered by any existing uncommitted appropriation.

The Department lists the indemnity in its internal indemnities register in order to facilitate reporting.

The Department implements the risk management plan to manage the risk.

⁸ Note that the insurance discussed in this case study is insurance coverage for the Department, not insurance coverage for the hotel. This case study does not deal with any requirement of the Department that the hotel have specific insurance. For examples of calculating the type and level of insurance to be required of contractors, please see the other case studies, in particular the case studies relating to a simple procurement of goods, a simple consultancy contract, and a contract for the provision of financial advice.

⁹ Note that the requirement is to obtain FMA Reg 10 approval prior to FMA Reg 9 approval, however, it is prudent to ensure FMA Reg 9 approval will be forthcoming before seeking FMA Reg 10 approval.

A SIMPLE CONSULTANCY CONTRACT

The Department is considering providing its considerable archive of film and television recordings to the museum as a resource and for possible display. The archive has existed for forty years but is not well organised. The records of the contents of the archive are contained on a mixture of paper file, magnetic tape, floppy discs and digital imaging software. Through previous failed attempts to compile the records in house, the Department has several copies of each set of records. The Department requires the following work to be completed before it can make an offer to the museum:

- construction of a database, listing the contents of the archive, from all of the disparate existing records;
- completion of an inventory check to establish the location and condition of each item on the list and, to the extent possible, to barcode the physical item for registration in the database; and
- research to establish the ownership and any other intellectual property rights existing in relation to each item and to value each item.

Through the conduct of a tender process, the Department identifies a consultant, Mr Stan Kubrick, to undertake the first step. Mr Kubrick's proposal is to work from his home office, on a stand alone computer to construct the database from the records. The database will use an application that the Department already uses in-house and will be provided to the Department on CD. Mr Kubrick's fee for constructing the database will be \$8,000, payable on delivery.

Complete a Risk Assessment

The Department conducts a risk assessment, which reveals that:

- the Department will not suffer any expense as a result of the late delivery of the database;
- the Department will not suffer any expense if the database is inaccurate as, in the second step it will be checked again, corrected and added to;
- the key risk to the Department is if the delivered CD contains a virus. This can be managed by opening the CD and reviewing it on a stand alone computer before uploading it to the Department's system. In fact, the Department doubts it would upload the database until it was completed through the second and third steps – which will be undertaken by other contractors and Departmental personnel; and
- Mr Kubrick will not work from Departmental premises, nor work on Departmental equipment. The material to be provided to Mr Kubrick is not unique and therefore its loss would not cause the Department any expense. None of the material provided contains confidential information or is subject to intellectual property rights. The Department was therefore unable to identify any circumstance where a third party would lodge a claim against the Department as a result of Mr Kubrick's actions in performing the contract.

Insurance Requirements

The tender documentation included the Department's standard form consultancy agreement which included a requirement for:

- \$10 million public liability insurance;
- \$15 million professional indemnity insurance; and
- an indemnity in favour of the Department for confidentiality and intellectual property infringement.

Mr Kubrick advised in his proposal that he did not comply with the standard contract's insurance requirements, and given the nature of the job considered this requirement unnecessary. He proposed the alternative position that no insurance was required.

The Department realised that this aspect of the standard for consultancy agreement should have been amended prior to being included in the tender documentation. On the basis of the Department's risk assessment the Department determines that:

- there is no need for Mr Kubrick to hold professional indemnity insurance as the Department would not suffer expense as a result of his failure to perform the services properly, other than the risk relating to the virus, which the Department was willing to manage itself;
- third parties were not likely to sue the Department over Mr Kubrick's actions in injuring them or damaging their property, so whether Mr Kubrick held public liability insurance was not of concern to the Department; and
- third parties were not likely to sue the Department for alleged infringement of intellectual property or breach of confidentiality as a result of Mr Kubrick's actions and therefore the indemnity provided no additional protection to the Department and could be removed.

Summary of how the justifiable level of insurance was determined

HIGHEST RISK THAT COULD REASONABLY CRYSTALISE (as determined by full risk assessment)				
Risk/s that require mitigation	Likelihood & Risk Level	Consequence	Risk Exposure	Insurance level Required
Work delivered on CD contains a virus	Possible (30%)	Moderate	Nil – can be managed before uploading.	Nil

A CONTRACT FOR THE PROVISION OF FINANCIAL ADVICE

The Department is conducting a tender process to select the builder for the museum in Darwin. It is concerned that the financial evaluation of the tenders will be quite complex because of current market conditions. In particular, the Department wants to identify whether tenderers:

- are significantly under pricing the construction;
- are financially sound or in danger of insolvency; and
- will be able to obtain the credit needed for the project.

The Department decides to engage a financial expert to assist in the evaluation and provide financial advice to the tender evaluation board.

Complete a Risk Assessment

The Department conducts a risk assessment which reveals that the critical risk to be managed is the provision of incorrect advice as this could result in:

- a failure to achieve value for money for the Department in the selection of the builder;
- potential complaints from disgruntled unsuccessful tenderers; and
- financial difficulties including insolvency of the selected builder causing delay to the project and additional expense to the Department if the builder has to be replaced.

The Department intends to ensure that it selects a financial adviser who is very experienced in providing the type of analysis required to mitigate the identified risks. It calculates that in a worse case scenario it would incur \$400,000 in additional cost if it had to re-run the builder tender process and compensate disgruntled unsuccessful tenderers. The Department obtains legal advice on what it would be likely to be able to claim from the financial adviser in various scenarios and determines the most probable amount that would be claimed for incorrect advice would be \$250,000.

Insurance Requirements

As the key risk is the provision of incorrect advice, the Department decides to require the financial adviser to have professional indemnity insurance to at least \$500,000 per claim. The amount is determined on the basis of the guidance in the Department's template contract for financial advisers.

The Department goes out to tender and receives two responses. The first is from Riskit and Associates, which is the company vehicle for an individual adviser who has had a lot of experience in financial analysis for similar Commonwealth tender processes. The second is from Wait & See Ltd, a large financial advisory firm.

Both tenderers have identified non-compliance with the insurance provisions and have proposed alternative insurance requirements. Riskit has an insurance policy worth

\$500,000 in aggregate per year but notes in its tender that, because there is only one adviser in the company, it works on only one project at a time. This project will take four months. Wait & See Ltd advises it has a \$200,000 per claim, \$1 million in aggregate policy. To emphasise its experience, Wait & See lists the large number of projects it is currently involved in advising.

The Department considers the responses in the context of its risk assessment. It realises that the level of insurance requested was higher than its assessment indicated and should have been set between \$250,000 and \$400,000 per claim. It also considers it extremely unlikely that more than one claim would be made in the circumstances. The Department considers the risks posed by each tenderer and determines that the Riskit insurance offer is more attractive because of:

- the per claim limit on the Wait & See policy;
- the higher number of potential claimants on the Wait & See policy; and
- the experience and working practices of Riskit.

The Department therefore evaluates the Riskit non-compliance in relation to insurance as lower risk than the Wait & See non-compliance in relation to insurance.

Summary of how the justifiable level of insurance was determined

RISKS THAT COULD REASONABLY CRYSTALISE (as determined by full risk assessment)				
Risk/s that require mitigation	Likelihood & Risk Level	Consequence	Risk Exposure	Insurance level Required
Incorrect Financial Advice	Possible (30%)	Moderate	most probable claim \$250,000	At least \$250,000 per event. Aggregate should be assessed taking into account all possible claimants on the policy.

PART 3 — MODEL LIABILITY CLAUSE

To assist in providing some consistency across Commonwealth agencies regarding the treatment of liability in Commonwealth contracts, a model liability clause has been developed to help clarify liability issues in contracts between the Commonwealth and small business.

The model clause has been developed in consultation with key agencies and industry, and while it has been developed with small business in mind, the clause may be suitable for use in any simple procurement contract.

The model clause sets out an explanation of the liability allocated between each party to the contract. It is intended that the model liability clause will be used as the neutral starting position for negotiation of procurement contracts. It is recognised that a one size fits all approach is not applicable and, as such, an alternative clause could be used if a full risk assessment shows it would be prudent to do so.

The model clause also includes an indemnity that requires a supplier to accept a level of risk that is consistent with both the level of liability the supplier would have under the general law and the principle that risk should be allocated to the person best placed to manage the risk.

It should be noted that the operation of legislation, such as Professional Standards Legislation, may also impact the allocation of liability between parties to a contract, regardless of the written terms and conditions of that contract. For example, the operation of the model clause could be affected where the supplier is a member of a professional association which has an occupational/professional standards scheme, which limits the civil liability of professionals to whom the schemes apply. The existence of such a scheme should be taken into account in the risk assessment for the relevant procurement. Agencies may wish to include a contract clause that notes the existence of the scheme but in doing so, care should be taken not to expand its operation beyond what would be the case under the legislation. Agencies should also investigate the effect of legislative limitations on liability on insurance policies held by contractors.

Agencies should consult with their legal advisers and Comcover if taking responsibility for a liability and in the course of negotiating insurance and indemnity, particularly if any agreement extends beyond common law.

MODEL CLAUSE

Liability

Explanatory Statement

(a) Where either party to this contract:

(i) breaches the contract;

(ii) is negligent; or

(iii) breaches a statutory obligation

it will be liable to compensate the other party to the contract, in accordance with the law, for any resulting expense suffered by that other party.

(b) Where a party has expressly agreed in the contract to take responsibility for a particular event, that party will also be liable to the other party, in accordance with the contract, for the expense suffered as a result of the event occurring.

(c) The term "expense" includes:

(i) loss suffered by a party to the contract, such as the loss of property;

(ii) liability incurred by a party to the contract to a third party; and

(iii) expense incurred by a party to a contract, such as the expense incurred in repairing damaged property or in defending a claim made by a third party.

Indemnity

(a) The Contractor indemnifies the Commonwealth against any expense caused by any negligent act or omission, breach of statute or breach of this contract by the Contractor, its officers, employees or subcontractors, except to the extent that any negligent act or omission, breach of statute or breach of this contract by the Commonwealth, its employees or agents contributed to the relevant expense.

(b) Where the Contractor has agreed in the contract:

(i) to provide intellectual property rights to the Commonwealth;

(ii) to maintain the confidentiality of material provided to the Contractor; or

(iii) to provide information to the Commonwealth

the Contractor also indemnifies the Commonwealth against any expense caused by a claim against the Commonwealth by a third party in respect of:

(iv) an actual or alleged infringement of intellectual property rights; or

(v) an actual or alleged breach of confidentiality

where the Commonwealth has acted in accordance with the contract.