Liable to succeed

Thoughts on limiting supplier liability

by David Newman

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TO QUOTE JUDAS in *Jesus Christ Superstar* "what's the buzz, tell me what's happening." Post 9-11, the buzz is about limiting corporate supplier liability on government projects. As a result of the September 2001 tragedy in New York, many companies are exposed to huge lawsuits threatening their very existence. And many corporate giants, let alone pilots on the insurance fleet, are worried sick about their risk management, fiduciary responsibilities to shareholders and loss exposure – especially in the litigation environment of our southern neighbour. Apparently, the problem is that many established government suppliers, based on risk assessments – risk management being that holiest of grails of 21st century management – are reluctant to even bid on major government procurements and projects that expose them to unlimited or unknown litigation risks.

If you're not part of the solution…

The scope of the problem is difficult to determine, partly due to the reluctance of highly reputed and respected suppliers to tarnish their images by not offering solutions, partly due to the policy and political issues at stake and partly due to the fact that, exaggerated or not, the problem is very real. In a recent "Chatroom," *Summit* touched on some of the issues with two IBM Canada experts, Public Sector Business Unit executive, Paul McCullough, and Legal Counsel Lindsay Gorrell. They helped put the issue of limiting supplier liability in perspective.

First, we're talking about very large and substantial projects for the most part – the kind the big players work on. Gorrell paints a very clear picture: "The liability concern with respect to anti-terrorism projects arises largely from third party claims. When you are talking about a project that involves installing, designing or developing systems to thwart terrorism,

Excerpts from the Treasury Board of Canada Policy on Decision Making in Limiting Contractor Liability in Crown Procurement Contracts (effective as of September 1, 2003)

Context

2.1 In contractual matters, contractors are responsible for managing risks and liabilities under their control. The Crown is responsible for managing risks under its control and for losses arising from those risks. This division of responsibility reflects both the common and civil law. Based on this legal principle, the Crown, may or may not include a clause (or clauses) in Crown procurement contracts, to ensure that it is protected from losses caused either by the contractor's performance of the contract or from the performance of the product or service delivered.

2.2 In certain circumstances, it is in the public interest for the Crown to assume all or part of a contractor's potential liabilities. This transfer of potential risk or liabilities is set out in a limitation of liability or indemnification clause. This policy addresses the use of these clauses. It provides for a risk-based, administratively efficient management regime that responds to program delivery challenges, recognizes market place realities, and supports effective stewardship of public funds.

Policy statement

4.1 **It is Government policy that:**

Protection of the Crown. The government will ensure that Crown procurement contracts provide for appropriate indemnification of the Crown.

Contractor responsibility. Contractors are responsible for managing risks under their control and must retain financial responsibility for losses arising as a result of the work they perform under contract, and in particular for liabilities from third party claims.

Exceptional transfer of risk. A substantive transfer of risk and potential liabilities of the contractor to the Crown, which would normally be the contractor's responsibility, should occur only in exceptional circumstances when there is a compelling reason in the public interest.

Risk- based implementation. Indemnification and limitation provisions are to be implemented in a way that is risk-based and administratively efficient, and supports due diligence by the Crown and contractors in managing risk and contract performance.

4.2 The main objective of this policy is to achieve a balance amongst the protection required by the Crown when entering into Crown procurement contracts, market place conditions and conditions important for assuring program and service delivery results.

Policy requirements

7.1 Departments are required to use the risk-based models described in detail in Annex 4 in order to support decision making when using clauses indemnifying or limiting liabilities of contractors. The four models are tied to risk-based management strategies to reflect the broad spectrum of circumstances in Crown procurement contracts. Decision trees found in Annexes 5 to 10 support these models.

Model 1: Standard commercial or military products and services and construction contracts commonly available in the marketplace.

Model 2: Complex developmental products, services and construction contracts.

Model 3: Contracts where there is limited scope for negotiating liability provisions, such as government-to-government agreements, or where no other viable alternative to serve a program requirement exists.

Model 4: Highly specialized services contracts in support of assuring the health, safety and economic well being of Canadians.

Responsibilities

9.1 Departments are responsible for Crown liabilities arising from their contracting activities, including contracting carried out for them by PWGSC. Departments are also responsible for losses contractors may suffer from risks that are under the control of the Crown or that are caused by the Crown's fault.

there is an element of third party claims over which you really have no control. The classic example is one in which a consulting firm installs the security system in an airport and a terrorist manages to slip through that security system. The consulting firm may have done its work perfectly and installed the security system precisely as the airport authority wanted it installed, and had reviewed and accepted the installation. Should an aircraft take off with a bomb in it, explode and a large number of lives are lost, the families bring suit against not only the airport. They are going to 'shotgun' their claims and sue the consulting firm and everyone else who may possibly be involved. Those are the kind of third party claims that worry consulting firms when it comes to these projects."

McCullough, a true sales professional, is not naming names, but he too has no doubt of the impact of liability risk. "There probably are a number of projects where solutions haven't been offered up [to government] by suppliers because of the risk of failure to be indemnified on implementation. The very least an organization would have to do would be to burden their proposal commensurate with the risk, and that could well render them uncompetitive. The bid could even go to those prepared to undertake the most risk rather than those prepared to offer the best innovation or solution. Often the firms that have the scale to offer global solutions – the ones that have the most to lose – decline in such circumstances. Smaller firms, or those who have relatively little to lose if they are bankrupted, have much less risk in bidding."

Indeed, in a June 2002 briefing, the Information Technology Association of Canada (ITAC) pointed out that "the Crown's approach to limitation of liability clauses has created a barrier for ITAC's members to sell information technology products to the federal government. Many members have "no-bid" procurement opportunities because of an unwillingness to accept risks resulting from the Crown's standard limitation of liability clause."

ITAC's position on limitation of liability (LOL) includes: "The IM/IT industry is requesting relief from liabilities for which it has no practical and reasonable avenues to protect itself. The industry's concerns are becoming more pressing as the Crown migrates to online service delivery and, as a result, shifts the inherent risks of its operations to suppliers who are expected to deliver solutions based upon the Crown's specifications and within the Crown's limited budgetary resources. Further, PWGSC has concluded that it is impractical at this time for the IM/IT industry to insure against these risks. Imposing onerous liability requirements unfairly favours financially weak suppliers because they have nothing to lose and gives the Crown a false sense of financial security."

Private and public sectors are not at loggerheads here. They are both well apprised of the issue, but it is just that complex – especially from a broad policy context. Suppliers and procurement specialists have an ongoing, constructive professional dialogue that permits them to identify policy and procedural issues that present both risk and opportunity to either or both parties. The Canadian Advanced Technology Association (CATA) Alliance and ITAC have had extensive discussions with governments on limitation of liability and related issues such as intellectual property. As ITAC states on their website, "after a few years of work with key influencers in Treasury Board and Public Works and Government Services, ITAC secured major changes in LOL. For all IM/IT procurement, Treasury Board has granted a special authority to PWGSC to limit liability. The clause agreed to in principal, and essentially what we see today in the RFPs, was created through a working group comprised of ITAC members and [Government of Canada] representatives."

What to do? What to do?

Solutions are difficult, both in the real world and the political world. Certainly

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Observations by the United States General Accounting Office on the United States *Terrorism Risk Insurance Act* of 2002 (TRIA)

AFTER THE TERRORIST attacks of September 11, 2001, insurance coverage for terrorism largely disappeared. Congress passed the *Terrorism Risk Insurance Act* (TRIA) in 2002 to help commercial property-casualty policyholders obtain terrorism insurance and give the insurance industry time to develop mechanisms to provide such insurance after the Act expires on December 31, 2005. Under TRIA, the Department of Treasury (Treasury) caps insurer liability and would process claims and reimburse insurers for a large share of losses from terrorist acts that Treasury certified as meeting certain criteria.

TRIA has enhanced the availability of terrorism insurance for commercial policyholders, largely fulfilling a principal objective of the program. In particular, TRIA has benefited commercial policyholders in major metropolitan areas perceived to be at greater risk for a terrorist attack. Prior to TRIA, we reported concern that some development projects had already been delayed or cancelled because of the unavailability of insurance and continued fears that other projects also would be adversely impacted. We also conveyed the widespread concern that general economic growth and development could be slowed by a lack of available terrorism insurance. Since TRIA's enactment, terrorism insurance generally has been widely available, even for development projects in perceived high-risk areas, largely because of the requirement in TRIA that insurers "make available" coverage for terrorism on terms not differing materially from other coverage.

Those that have purchased terrorism insurance may still be exposed to significant risks that have been excluded by insurance companies, such as nuclear, biological, or chemical contamination.

Congress had two major objectives in establishing TRIA. The first was to ensure that business activity did not suffer from the lack of insurance by requiring insurers to continue to provide protection from the financial consequences of another terrorist attack. Since TRIA was enacted in November 2002, terrorism insurance generally has been widely available even for development projects in high-risk areas of the country, in large part because of TRIA's "make available" requirement. Although most businesses are not buying coverage, there is little evidence that development has suffered to a great extent—even in lower-risk areas of the county, where purchases of coverage may be lowest. Further, although quantifiable evidence is lacking on whether the availability of terrorism coverage under TRIA has contributed to the economy, the current revival of economic activity suggests that the decision of most commercial policyholders to decline terrorism coverage has not resulted in widespread, negative economic effects. As a result, the first objective of TRIA appears largely to have been achieved. Congress's second objective was to give the insurance industry a transitional period during which it could begin pricing terrorism risks and developing ways to provide such insurance after TRIA expires. The insurance industry has not yet achieved this goal.

As part of the response to the TRIA-mandated study that requires Treasury to assess the effectiveness of TRIA and evaluate the capacity of the industry to offer terrorism insurance after TRIA expires, we recommend that the Secretary of the Treasury, after consulting with the insurance industry and other interested parties, identify for Congress an array of alternatives that may exist for expanding the availability and affordability of terrorism insurance after TRIA expires. These alternatives could assist Congress during its deliberations on how best to ensure the availability and affordability of terrorism insurance after December 2005.

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there is a perception, true or not, that it could be politically unpopular to pursue a course of action that could be seen, or sold, as unfriendly to the little guy – a point that does not escape the sophisticated insights of larger firms. Gorrell told us that "a particular concern of large consulting companies is that they would like to be able to form an association or group to approach the Canadian government to bring attention to the problem – the issues of risk and liability. The government certainly understands all of this. The problem is the small companies out there who are willing to bid on these projects whereas the larger companies stay away under the current circumstances. Where these [small] companies win these projects, they may well be judgment-proof – that is willing to go under if they are liable. That creates a feeling among large firms that they cannot put significant pressure on the Canadian government at any level to offer up their solutions."

There have already been strong government responses to these problems (see sidebar, pages 16-17) and no doubt there will be more. Some have been legislative, some regulatory, others based on pools of money set aside for contingency. Though no one we spoke to observed so directly, it may be that this a problem that confounds traditional solutions and requires more policy or political re-engineering than we may want to take on.

Also worth noting is that this issue is not unique to government procurement. Other public and private sector organizations – for example, universities, hospitals, television studios, plantations, nuclear plants, chemical factories, dams, banks and even high technology laboratories – are involved in mega infrastructure and technology projects. Insurers or self-insurers, for the most part hold their liability. Why then the added pressure on governments to offer up limited liability for their mega-projects? Does it serve to take the pressure off the insurance, reinsurance and investment industry? Perhaps we need to invent a new approach to insurance and liability issues, or even, to address the overall atmosphere of such a highly litigious society.

And then there is the nature of terrorism. Though the private sector can be a victim of terrorism, government is the most frequent target. By limiting the exposure to liability of suppliers, the government takes on an added burden of responsibility and liability. Does that weaken government and play into terrorists' hands? Do we see a terrorist act as an act of war?' Where was the liability in past formal wars – for the bombing of London or Berlin, for ravaged and looted works of art? Are we distant enough from the 9-11 trauma to ask how it differs from the sack of Rome – were the Mongol hordes terrorists? These and other questions need to be addressed in a broadly-based societal policy context.

The past is present for the future

How does our 'system' respond to these 'new' realities? Historians often tell us to learn from the past; new realities are perhaps not so new. Canada has more than a few examples that could be relevant.

Just after Confederation, there were no companies in Canada with the wherewithal or capacity to build a cross-country railroad, let alone anyone who felt the return on investment justified the expense. So Canadians invented a joint government/private enterprise, the CPR, to get it done – our first P3 if you will. Could today's new challenge require a new twist on partnership or joint venture approaches?

Back in the 'dirty thirties,' when the entire insurance industry showed complete disinterest in insuring vehicles and property, the Province of Saskatchewan, followed later by Manitoba and British Columbia, founded their own state insurance companies. They still exist today. Others responded in a more private sector fashion by establishing a 'Co-operators' co-op insurance company. Does one answer exist in somehow restructuring the industry?

Is this another case like Y2K, where we would be irresponsible not to respond, or are the boys crying 'wolf'? One thing is sure – though it goes far beyond procurement issues – limiting liability is a procurement issue and procurement specialists had best be engaged and be part of the solution.

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