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ASK THE EXPERT CALL - 12TH JANUARY 2012

Managing Risk in Key Contracts - Service Credits, Indemnities and Liability Limits – are they fit for purpose?

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1. Q - The topic of this call is "Managing Performance and Risk in Key Contracts: Service Credits, Indemnities and Liability Limits – are they fit for purpose?" Firstly, I understand this talk focuses more on the commercial aspects of this subject rather than a look at the underlying legal principles. What was it that made you think about speaking on this topic?

   A - Recently I have been involved in half a dozen projects where service credit regimes and very broad indemnities have been key areas of focus for the parties and proved major obstacles to concluding the contracts in question. It just struck me that the approach taken by the parties was not terribly constructive, damaged relations between the parties at the outset and significantly increased the time and therefore the costs of the procurements.

2. Q - Could you briefly explain what you mean by each of these terms, starting with Service Credits?

   A - Service Credits are a pre-agreed regime of credits against future charges calculated on a scale of measured levels of performance. They are a form of liquidated damages and are typically:
   - calculated on a periodic basis;
   - subject to a cap (perhaps 10-15% of monthly fees); and
   - often stated to be an exclusive remedy for performance within that cap.

3. Q - What about indemnities – what are they?

   A - An indemnity is a contractual obligation to indemnify or 'hold harmless' an innocent party from the consequences of a particular breach of contract. Indemnities are most commonly found in the context of intellectual property infringements where a supplier is required to give an indemnity against any third party claims that the customer will breach a third party's IPRs by using a deliverable or service. The effect of the indemnity is that if that third party brings such a claim against the customer, then the supplier underwrites the liability incurred by the customer as a result.

   However, I have seen on several occasions and in particular recent transactions that I have worked on, indemnities that have been requested which cover a much wider scope than just third party claims of the nature I have described, such as general breaches of contract and even regulatory breaches.

   Key features of an indemnity to understand are:
   - they are entirely dependent upon the drafting for their scope;
   - you need to consider whether they just cover third party claims or extend to include the indemnified party's own losses;
   - the indemnifying party typically takes control where a third party claim is involved.

4. Q - Could you give us an example of what you would consider to be a very wide indemnity?

   A - Yes, the following wording is taken from a recent contract I was asked to look at. It is an extremely wide indemnity.

"The Supplier will fully and effectively indemnify each Indemnified Entity on written demand against any and all Loss that may be assessed or awarded against or incurred by any Indemnified Entity arising out of or in connection with:

- *any intentional, fraudulent or negligent act or omission of the Supplier;*
- *any breach of Supplier's representations and warranties under this Agreement."*

"Loss" in this provision was defined as meaning *"any loss, liability, claim, damage, death, injury, cost (including legal and other professional costs and expenses) or expense of whatsoever nature"*. This is also very broad.

5. Q - Limitations on liability are a common feature in the vast majority of commercial contracts but can you give a short explanation of what they are used for and the Courts' attitude towards them?

A - Essentially, a limitation of liability clause provides a financial cap on a supplier's or service provider's liability (for breach of contract, negligence etc).

In more recent years the English Courts have generally been more prepared to uphold financial limitation clauses than they did previously and recognise their legitimate commercial justification as a reasonable apportionment of risk. Please note, however, that an argument to justify a particular limitation clause along the lines that such a limitation is 'industry standard' is not viewed particularly favourably by the Courts.

Also, the Courts' decisions on what limit is reasonable have not been entirely consistent and there are no guarantees that even if best practice is followed, clauses will necessarily be upheld. Although strictly irrelevant, much seems to depend upon how the particular conduct of the supplier is viewed by the Court and judges can be very ingenious in finding ways of circumventing clauses where they feel that is necessary in the interests of justice.

Many liability clauses have different caps for damage to tangible property and for other types of damage.

Most clauses are in some way related to the value of the contract. The limit varies but, in long-term service contracts, it is often stated to be the sums paid or payable in a 12 month period or to a small multiple such as 125%.

6. Q - We will look at limitations on liability more a bit later but can you give an example of a clause that you have seen lately?

A - Yes, the following wording is taken from a long-term services contract where the customer asked for a cap of one and a half times the Annual Service Charge. The supplier found this quite difficult to justify given it meant its potential liability was significantly greater than the payments it would actually be entitled to receive in a year and certainly its level of profit (which was less than 10% of revenue).

"The Supplier's liability whether arising from negligence, breach of contract or otherwise under or in connection with this Agreement shall in no event exceed, in any Contract Year, an amount in aggregate equal to one and a half (1.5) times the Annual Service Charge for the relevant Contract Year (prior to the calculation of any reduction to the Annual Service Charge pursuant to this Agreement)."

A couple of thoughts on this. The clause talks in terms of maximum liability. That begs the question as to whether liability includes (a) the internal costs of any additional work which is carried out by the service provider; and (b) any waiver of the charges granted by or negotiated with the service provider?

7. Q - We said earlier that this was not a talk about the law, but can you provide some background on the overall legal position under English law in relation to service credits, indemnities and limits on liability?

A - Basically, for **service credits**:

- If they are set too high, they could in theory amount to a penalty (i.e. not a reasonable pre-estimate of likely loss) and they could therefore be unenforceable.
- If they are set too low and are stated to be an exclusive remedy, they could be deemed unreasonable as they could be considered to operate as a limitation on liability and therefore subject to the rules of the Unfair Contract Terms Act (UCTA).

However, it is extremely unlikely that a service credit regime between two commercial organisations will be struck out, so it is almost guaranteed that whatever regime you set out in the contract, will be applied and enforceable as written.

Indemnities are not subject to the test of reasonableness under UCTA and will depend on the terms as they are written in the contract. So if the wording of the indemnity is very wide, the indemnifying supplier/service provider will be bound by it even if it appears unreasonable. This is why very careful attention should be paid to the precise terms of any indemnity.

Limitations of liability are generally subject to the UCTA reasonableness test or in circumstances where UCTA may not apply the Courts often appear willing to apply an equivalent common law test.

8. Q - So why are these mechanisms included in contracts and by whom? What is their purpose?

A - Generally speaking, **indemnities** are requested by customers and the reason is to transfer risk from them to the supplier/service provider. Indemnities are, in my view, most appropriate when dealing with a specific, self-contained risk/liability, preferably one in which the indemnified party has no independent interest in the outcome and so is prepared to stand aside. Indemnities are sometimes used as an attempt to avoid the uncertainties inherent in common law damages claims concerning principles such as remoteness, foreseeability of damage, causation and duties to mitigate.

However, customers who insist on indemnities should beware of the reckless supplier who simply signs up to any indemnity without really considering the consequences. The presence of an indemnity may provide a false sense of security. Are there better, more pragmatic ways of mitigating risk, ensuring the event covered by the indemnity never happens? How likely is it that the indemnity will need to be invoked? Will the indemnifying party have the resources to satisfy any indemnity if called upon? Is the indemnifying party demonstrating a reckless disregard of risk simply to secure the contract? Will they demonstrate the same recklessness in relation to performance?

Liability limitations are most often used by suppliers/service providers to limit their risk and to make contracts affordable. If a supplier has unlimited liability this may be disproportionate to what it is being paid and it may have to increase its prices to factor this in, which can make the contract unaffordable or poor value for money for both parties.

Sometimes, however, it can pay off to be a generous supplier. Given that liability clauses are one of the most contentious and frequently discussed topics for those involved in negotiating and drafting commercial contracts, it may be sensible to minimise this by agreeing to a higher limit upfront. This is best illustrated by a client I had some years ago who was in the disaster recovery business and essentially had to make standby IT facilities available to its customers in the event of a disaster. The client told me that his sales teams were always spending a great deal of time negotiating the liability cap.

I suggested increasing the liability limit very significantly (by around 500%). This meant that the process of concluding contracts was made much simpler and quicker but without actually significantly increasing the client's risk. Risk is a factor of two things, not just what the potential liability might be but how likely a breach is in the first instance. In this particular case the client had a perfect track record and felt that the risk of a breach was extremely low. Therefore any greater risk from increasing the limit was very small. Indeed, the supplier was able to use the increased limit as a positive marketing tool. By offering a limit higher than its competitors, the company was able to offer more favourable terms to potential customers, positively demonstrate its confidence in its service and gain a competitive advantage.

Service credits are intended to avoid conflict during the performance of a contract because the parties will have pre-agreed the service credit regime in advance. For customers they provide a relatively simple means to obtaining compensation for a poor level of service without the need to prove actual damage (which in some cases could be very difficult). A service credit regime also provides a means by which performance can be readily measured.

For suppliers, service credit regimes provide a degree of certainty. The degree of risk can be evaluated particularly where the regime is the exclusive remedy.

In some senses therefore it could be argued that service credit regimes are in both parties' interests. However, I often suspect that suppliers view service credit regimes as a form of defence against liability. Recently after spending many hours trying to agree a regime on behalf of a customer without success, I made the suggestion that perhaps it would be better to omit the service credit regime entirely. The supplier was clearly extremely nervous about this which perhaps suggests that it thought it was much better off with the 'shield' of the regime to protect it. As a result agreement followed quite quickly afterwards.

9. Q - So, now we understand their purpose, do they in reality achieve their purpose?

A - For **Service Credits**, I would have to say on balance, no. This is because:

- Service credit regimes are highly contentious and difficult to negotiate.
- They are almost without exception overly complex and often neither side understands properly how they are to work in reality. In addition, sometimes extra resource is required just to monitor the service levels and produce accompanying reports which is a further cost. The supplier either has to bear this cost making the contract less profitable or the customer has to pay for it because the supplier factors this into the price for the services.
- They often lead to an inappropriate focus when there are more important aspects of the contract to concentrate on [like ensuring the specification is clear and unambiguous].
- There is usually uncertainty over what should properly be measured and lots of re-inventing the wheel occurs in putting together the regime in the first place.
- Service credits can operate as a frustrating barrier and rarely provide a realistic remedy because the value of the credits may be very low.

For **indemnities**, I would also have to say no. This is because:

- Indemnities suggest you are looking for a risk underwriter.
- There is an emphasis on the consequence of breach rather than preventing the breach in the first place. A recent example I have of this is where a customer asked the supplier I was acting for to give an unlimited indemnity in respect of breaches of data protection and other regulatory provisions. There was a right in the contract for the customer to undertake a regulatory audit but no obligation on the customer to tell the supplier the outcome of that audit or any remedial measures that might be required. We asked the customer to accept a mandatory contractual obligation to carry out an annual audit and inform the supplier of the

outcome. By doing this, any potential issues could therefore hopefully be proactively addressed rather than waiting for a breach and simply relying upon a financial indemnity.
- Indemnities by themselves do not avoid arguments over responsibility and the amount of the claim.
- Often, customers will not want to hand over the defence of a third party claim.

For **limits on liability**, be aware that in cases where they are most needed by suppliers/service providers, they are often found not to provide protection. The Courts seem perfectly prepared to engage in 'legal gymnastics' to exploit any perceived weaknesses in the drafting and to consider clauses in the light of the perceived behaviour/fault of the supplier/service provider. Also bear in mind that if a limitation is held to be unreasonable by the Courts, they will not rewrite the limitation to make it reasonable, they will simply strike it out.

10. Q - So what can be done then to improve the position?

A - Well, in relation to **service credits**, suppliers/service providers should have well-thought through, adequately tested service credit regimes available in advance. Often, suppliers have not worked out what their 'standard' service credit offering looks like, instead almost starting from scratch or asking the customer to come up with a suitable performance measuring mechanism, hence re-inventing the wheel unnecessarily.

For customers who are considering a service credit regime:
- You should understand what the regime is and that it is often an exclusive remedy.
- You should also be realistic about what could and should be measured and bear in mind that some breaches are simply inappropriate for a credit regime.
- Don't try to make the regime too complex and ensure that regimes are thoroughly stress tested.
- Lastly, ensure that the regime is suitably limited in scope – focus on the thresholds at which other remedies become available.

For **indemnities,** suppliers should:
- Understand the scope of the indemnity they are giving.
- Be prepared to challenge the customer's justification for the need for an indemnity.
- Consider the relationship with the limit on liability - is there an unresolved conflict?
- Make sure your insurers are fully aware of what is being agreed – indemnities are often wider than general liability at law and failure to disclose wording of an indemnity that the insurers are not aware of may leave you without cover.
- Do not regard insurance as a panacea.

If you are a customer, then in relation to indemnities, you should:
- Not regard indemnities as a solution for everything; indemnities are only a very limited part of a risk management strategy.
- Consider whether they are appropriate to the particular subject.
- Think about whether you would want to hand over control of the claims covered by the indemnity?
- Consider if they send out the wrong message making contract negotiation almost impossible?
- Ensure the contract contains mechanisms designed to pro-actively prevent the worst happening such as the mandatory compliance audit.

With regard to **limits of liability,** suppliers should:
- Consider carefully and document the reasoning behind the limitations you include and take into account the insurance cover you have.

- Think about whether increasing the limit genuinely increases your risk.
- Weigh up whether the limit can in fact demonstrate a positive sales message to potential customers.
- Be conscious that no limit is ever completely watertight.
- Consider carefully exactly what the limit as drafted actually means – does it, for example, take account of any reduction in the charges?
- Do not regard insurance as a panacea.

If you are a customer, then in relation to limits of liability:

- Do not regard a higher limit of liability as a cure-all; seeking damages from a supplier is only a very limited part of a risk management strategy.
- Focus on the overall risk and ways of managing that risk. How likely is it that the supplier will fail? Is the specification sufficiently clear and robust?
- Be aware of trends in the market.
- Be clear as to your position at an early stage in contract negotiations; this significantly improves your negotiating position.

11. Q - Finally, do you have any overriding conclusions?

A - Yes, basically, we must do better! Current practices place a great strain on the customer/supplier relationship and significantly increase the cost of sales/procurement.

For those who would like to understand more about limiting and excluding liability under English law, we have written a non-legal guide for those involved in negotiating commercial contracts. If anyone would like a copy, it can be downloaded for free from the Legal Update page of our website (www.trglaw.com).

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