CONTRACTPROBE

Managing the Contractual Risks when responding to Government Tenders

Government contracts are lucrative and governments hold a strong bargaining position in many contractual negotiations. The desire to win a particular piece of work might occasionally lead to critical legal risks being accepted. The aim of this guide is to explain some of those legal risks so that an informed decision can be taken as to whether or not the risks should be accepted.

The below comments are for general guidance only and do not constitute the provision of legal advice.

1. One-sided clauses that should be mutual

Government contracts are highly sought after and often awarded by competitive tender. It is accordingly important that bidders pick their battles in a way that balances the competitiveness of their bid against the risks being accepted under the contractual terms.

Where a provision is one-sided or unreasonable, requesting that it be redrafted so as to be mutually applicable can often be a good way of raising the issue and highlighting its unreasonable nature. It might prompt the Government either to amend the unreasonable aspects of the clause or give the bidder an equivalent right.

Similarly, submitting both a compliant and non-compliant bid with prices reduced accordingly will draw the Government's attention to the benefit for it of accepting a more reasonable position on the contractual terms. This approach ensures that the bidder has both a commercially competitive and balanced offer in play.

2. Force majeure clauses

Force majeure clauses are often tucked away at the back of a contract and given scant regard during negotiation. Recent history, in particular the Covid pandemic, has shown that these clauses are far too important to be treated in this way. They provide a list of potentially "frustrating events" which either bring the contract automatically to an end, absolve one party of liability or give rise to a right of termination.

From a supplier's point of view, force majeure clauses should be written as a non-exhaustive list and not as a restrictive definition. The phrasing "force majeure includes" is preferable to "force majeure is" or "force majeure means", both of which might be read as exhaustive. This keeps the list of potentially frustrating events open and allows for the inherent difficulty of forecasting all causes that might impact on performance. In light of recent history, any list of force majeure events should always include pandemics.

It is often difficult to know in advance how a force majeure event might affect the performance of a contract – will it only affect certain parts of the contract or will it cut across the contract as a whole? And will it make performance impossible, or just delay the time for completion? Given these uncertainties, you need to check that the force majeure clause applies to the contract generally and not just to specific provisions. Moreover, bidders should request a right to terminate if the force majeure event persists for longer than a certain period. This allows for an escape from contractual obligations where a long-term, destabilising event affects performance, with likely consequences on the cost of supply.

3. The risk allocation clauses: Indemnities and Warranties

These clauses (otherwise known as the lawyers' picnic ground!) can result in a supplier being liable for losses for which they would not otherwise be liable. They need to be considered carefully to ensure that the risks allocated to the supplier are reasonable in the context of a particular supply. For example, a warranty that the supplied materials will not contain any defects might be acceptable in a contract for supply of physical goods. It should not be accepted in a contract for the supply of software, as it is generally impossible to ensure that any software is totally free of defects. At the very least such a warranty should be qualified by the word "material", so it does not apply to trivial bugs in the software.

Indemnities should be scrutinised particularly carefully as they have the potential to make a party liable for acts over which they have no control and should not be responsible. The normal common law rules protecting a supplier against damage that is too remote, and requiring a customer to mitigate their losses, will not always apply to indemnities. In addition, indemnities are also often an exception to the agreed cap on liability in the contract or to the contract's exclusion of consequential loss clause, so they represent a potential source of unlimited liability for indirect losses. Not nice!

When considering an indemnity you should always ask, is the subject matter of the indemnity properly something for which an indemnity is needed or should the customer simply rely on their rights for breach of contract? If damages for breach of contract would protect the Government adequately then the indemnity should be rejected.

4. Exclusion of certain types of loss

The losses that a party suffers from breach of contract can be broadly categorised as being either “direct” or “indirect”. A direct loss is typically the value which was lost as a result of incomplete performance of an obligation. For example, a car manufacturer who contracts to have 10 tonnes of steel delivered, but receives only 7, may sue for the cost of the 3 tonnes which were not delivered.

“Indirect” (also known as “consequential”) losses are losses beyond a party’s direct loss. This may include loss of profit on subsequent transactions. For example, if insufficient steel was delivered, the car manufacturer’s inability to meet orders placed on it may cause it further losses in terms of lost profits, cancelled orders, lost customers, and wasted expenditure. The amount of indirect losses is much harder to predict in advance and can include factors over which the supplier has no control.

It is normally in the bidder’s best interests to exclude indirect losses totally from the contract. The wording of such exclusions is very important. Think carefully about what type of losses the customer might suffer if the contract is not performed successfully and then exclude those types of loss expressly. For example, if the customer might waste money or lose profits because the project is not successful then exclude “wasted expenditure” and “lost profits” expressly. Do not rely on vague words such as “indirect losses” to exclude these types of damages.

5. Capping certain types of loss

The contract should cap the maximum amount that can be recovered for those types of losses that are not excluded totally. That ensures that the supplier is not potentially liable for far more than the contract is worth. There are four common traps worth looking out for in these capping clauses.

First, many Government contracts contain clauses relating to Professional Standards Schemes. These clauses afford limitations on liability for contractors who are members of professional bodies that are registered under the scheme. The clause will not apply if the contractor is not part of such a body. It is therefore essential to check if the provision will apply. For example, engineers are not currently registered under the scheme and therefore would not be protected by a clause of this kind.

Secondly, some limitation of liability provisions only apply for liability arising under certain clauses of the contract. The bidder should request a global maximum for liability under all clauses of the contract.

Thirdly, check that the amount of the cap is fair given the amount you expect to earn under the contract. In supply agreements, for example, bidders might request that liability not exceed the total amount that they are to be paid under the contract.

Finally, contractors need to pay particular attention to any exceptions to the clauses. For example, there may be an exception for liabilities under the indemnities in the contract or for losses arising out of ‘death, injury, disease or illness’ or for ‘breach of confidence’. Contractors should consider whether these exceptions are reasonable and check that the exception only applies to loss caused by the contractor’s own wrongdoing.

6. Proportionate liability

Each Australian State and Territory has passed laws that limit a party’s liability to the proportion of loss that they cause. In NSW, for example, the relevant legislation is the Civil Liability Act 2002 (NSW) – Part 4. Some Government contracts will exclude the application of these laws, using language such as “The parties agree that the provisions of the Contract exclude the provisions of a Proportionate Liability Law”.

It is generally in the bidder’s interest, even in a tender situation, to maintain the application of proportionate liability legislation. This is because the legislation will generally protect the bidder from being liable beyond their proportion of fault. If the legislation is excluded then the bidder may be liable for the full extent of any loss, even if they only contributed to a small part of it. Contracting out of proportionate liability legislation may also reduce the bidder’s ability to claim under its insurance should something go wrong in the supply, as they have assumed liability beyond that which would apply at law.

A bidder would have a strong argument to insist that clauses excluding proportionate liability legislation be removed. Not only are they unfair but they normally apply mutually.

Although the proportionate liability legislation will typically be for the supplier’s benefit, they can sometimes also protect the customer. For example, if several parties, including the Government contribute to a loss, but only the Government has the funds to pay, the supplier will not be able to claim the full amount of its loss from the Government but can only claim from the Government the percentage that the Government has itself caused. In those circumstances it would be better for the supplier to have the proportionate liability legislation excluded. However, in general, it will be the supplier that has the most to gain by allowing the proportionate liability legislation to apply.

7. Subcontractors

Government contracts may request that any subcontractor also submit to some or all of the terms of the main contract. If a bidder intends to use subcontractors, they should check these provisions with any key subcontractors before accepting such an obligation and consider how those additional obligations might affect the subcontractor's price.

8. Insurance

Similarly, Government contracts often insist that certain insurance requirements are met. If such an obligation would require the bidder to take out additional insurances, or to change the terms of its existing insurances, then the associated costs should be taken into account when preparing the bid.

The insurance obligations might also continue for several years past the termination of the contract. The cost of maintaining the insurance for this additional period of time should also be taken into account when pricing the bid.

Finally, check carefully any obligations that might require you to change the terms of your existing insurance policies. For example, an obligation to "note" the interest of the Government on an insurance policy needs to be checked with your insurer before being accepted. Provisions such as this may sometimes result in the insurance premium being increased, which will need to be reflected in your pricing for the bid.

9. Precedence of documents

Government contracts will often list a 'precedence of documents'. This is essentially a hierarchy for resolving any ambiguity or inconsistency between the various parts of the contract wherein the main instrument usually takes top priority. An example is shown below:

The Contract is comprised of:

a) Additional Contract Terms (if any);
b) Statement of Work;
c) Government Contract Terms;
d) Government Contracting Suite Glossary; and
e) Contract Annex 1

If there is ambiguity or inconsistency between documents comprising the Contract, the document appearing higher in the list will have precedence.

A clause drafted in the above terms allows a bidder to include important protections in their Statement of Work, which can be a convenient way to deal with any technical or commercial risks arising out of the supply. If there is subsequently a dispute, this type of language will raise a clear inconsistency and the statement of work will prevail.

Some other precedence clauses, though, do not allow this approach, such as the following:

If there is any inconsistency between parts of the Contract, a descending order of precedence shall be accorded to:
a) the COC (including the Details Schedule) and the Glossary (other than the referenced documents in the Glossary);
b) the SOW and any annexes;
c) the attachments other than the SOW and the Glossary; and
d) any document incorporated by express reference as part of the Contract,
so that the term in the higher ranked document, to the extent of the inconsistency, shall prevail.

In this clause the Conditions of Contract prevail over the Statement of Work. So if there is any inconsistency between the two the COC will prevail. This will generally not be what the bidder would want. Where this type of wording is used, it will accordingly be important to ensure that the SOW is checked carefully for any potential inconsistences and those inconsistencies are expressly resolved in the Details Schedule.

10. Right to reject

If the contract contains a right for the customer to reject the supplied goods or services, the test for rejection should be objective and the conditions for rejection specified clearly. If the customer has a subjective right to reject, or the conditions are expressed vaguely, the Government will have a substantial discretion to avoid paying for those goods or services, even if the supplier considers it has done everything it needs to do.

11. Right to price variation

Government contracts can be long-term arrangements and often have provisions permitting their extension. In such contracts a supplier should consider requesting a clause which allows for the price of the contract to be varied during the life of the agreement. The variation can occur automatically, as with a CPI indexation clause, or in accordance with some agreed process, such as a benchmarking provision.

12. Rights to terminate

A Government will often seek a right to terminate a contract for convenience; that is, for any reason or no reason at all. Governments will typically seek to justify such clauses on the basis that they need the freedom to accommodate changes in Government policy. Despite their inherent unfairness, a supplier is likely to have to accept such a clause in order for its bid to remain competitive. Suppliers should nonetheless protect themselves against the consequences of terminations of this kind. One method of doing that is to factor any potential terminations of the contract into the business model and adjust the price of the contract accordingly. Another method is to negotiate an appropriate break fee to be paid in the event of such a termination.

The Government will also typically have a right to terminate for certain breaches of the agreement. The contract should allow a period in which breaches or defects can be rectified by the defaulting party, with the period allowed for rectification being of reasonable length. Some contracts we have seen state a period as short as 24 hours and the bidder should think carefully whether such a short period of time will be enough in all circumstances.

Bidders should also check that they should have an equal right to terminate a contract for the Government’s breach.