ARE SUBCONTRACTORS LIABLE TO THE ULTIMATE CUSTOMER? A ROLLS-ROYCE ANSWER

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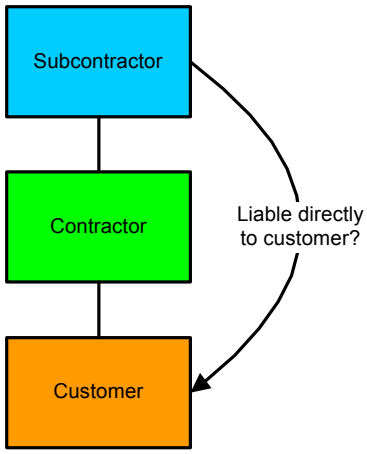
With increasing complexity, more and more projects (including IT and telco projects) involve a prime vendor using subcontractors to provide a total solution. The subcontractor's negligence might cause loss to the ultimate customer. If things go wrong, can the subcontractor be liable to that ultimate customer? Generally the subcontractor doesn't have a contract with the ultimate customer.

Sometimes a party that doesn't have a contract with another can be liable directly to that other party (usually under the law of tort including negligence).



Typically in their contracts, the head contractor will limit its liability to a customer and, in turn, the subcontractor will limit its liability to the head contractor. Although a desirable outcome, these limitations won't always be "*back to back*" so that they overlap, to create a seamless regime.

In a 2004 case, *Rolls-Royce v. Carter Holt Harvey*, our Court of Appeal decided that the subcontractor in that construction case could not be liable to the customer.

Generally trying to exclude liability of the subcontractor to the ultimate customer in the contract between the head contractor and the subcontractor will not be effective.

The conclusions are largely applicable to IT and telco projects. Although the outcome will depend on the circumstances of each case, and the position is not entirely clear, generally the subcontractor will not be liable to the ultimate customer unless there are particular circumstances such as breach of the Fair Trading Act. We deal with some solutions at the end of this article.

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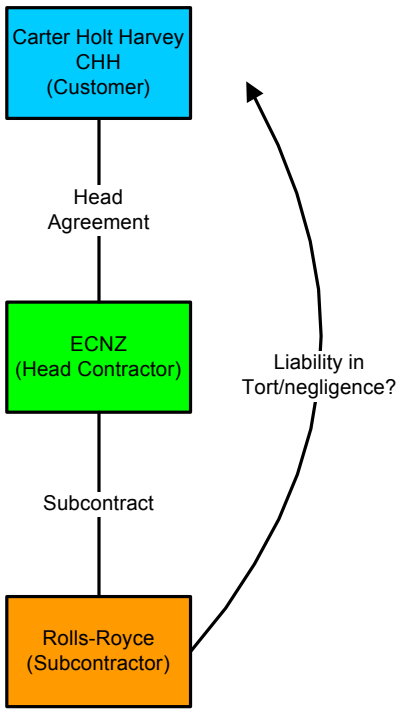
1 What happened between Rolls-Royce and Carter Holt Harvey?

1.1 *Rolls Royce v. Carter Holt Harvey*[1] is a good example for the IT and telco industry because many of their methodologies and contract forms derive from the building and construction industry.



1.2 Carter Holt (CHH) wanted to build an electric power plant at its Kinleith Mill. It contracted this out under a head contract to ECNZ. ECNZ in turn contracted a high proportion of the project to power plant specialists, Rolls-Royce.

[1] (CA 259/02, 23 June 2004, with conditional leave to appeal to the Privy Council refused on 7 October 2004).

1.3 All three knew about the relationships, and CHH had even read the ECNZ-Rolls-Royce subcontract. The Rolls-Royce people were frequently talking to CHH both before and after the agreements were signed.

1.4 As is usually the case, ECNZ as head contractor limited its liability to CHH and in turn Rolls-Royce limited its liability to ECNZ under the subcontract. Also as is usual, the head contract did not specifically exclude the subcontractor's liability.

1.5 CHH said that things went wrong due to Rolls-Royce' negligence. So it sued ECNZ under the head contract and it sued Rolls-Royce. As it had no contract with Rolls-Royce, it sued not under contract but under the tort of negligence.

1.6 It's well established that, even between contracting parties, there can also be liability in tort. Tort is a liability which arises independently from contract and includes negligence (the particular breach alleged here), although the contractual matrix is highly relevant to whether or not the tort of negligence arises, and its scope and nature.

1.7 Generally the scope and nature of the liabilities for negligence will overlap with the contractual liabilities (as the Court of Appeal confirmed in this case). However, one of the risks for Rolls-Royce was that, if it was liable direct to the ultimate customer (CHH), its limitation of liability clause may not be effective (and so CHH could get around the limitation of liability in the head contract with ECNZ). This was a strong reason to sue Rolls-Royce, as limitation of liability is often the main barrier to a major $ claim. All this would go against comprehensive and carefully worked out agreements between commercial parties. And indeed that is one of the reasons why the Court of Appeal decided that Rolls-Royce would not be liable to CHH. That would upset the carefully worked through arrangements between commercial parties, who are well able to look after themselves by contract.

2 Subcontractor's negligence liability to the ultimate customer

2.1 Whether or not a party is liable in negligence in novel situations (such as this) is the subject of legal principles which are often controversial. Those principles are notorious for the way they have evolved and changed over the years.

2.2 When the Courts are dealing with a novel situation, they tend to move incrementally from existing cases, and look first at:

2.2.1 the proximity between the parties (that is, whether they are closely related and part of a tighter group) and then;

2.2.2 the policy reasons for and against imposing negligence liability[2].

2.3 Very important, where contracts are involved, is the contractual matrix, and whether parties have assumed responsibility to others. Here, this issue was decisive. It would not be right to alter, using the negligence mechanism, the carefully worked through arrangements between the parties by which they allocated risk and responsibility by way of the head contract and the subcontract. It didn't matter that, as is usual, neither the subcontract nor the head contract specifically stated that the subcontractor (Rolls-Royce) could not be liable to CHH.

2.4 No prediction in the area of negligence liability can be entirely safe as it can be something of a moving feast. In particular, each case is dependent on its own facts. However, even though there were some unique features here (including that it was a construction contract, not an IT/telco project, and that the ultimate customer (CHH) had in fact seen the subcontract), generally this decision gives comfort that, usually, subcontractors won't be liable in tort/negligence to the ultimate customer[3].

2.5 There remain risks however. The best example is the risk of liability under the Fair Trading Act (for example in relation to statements made during the sales process by the subcontractor to the ultimate contractor (or even in some situations by the subcontractor to the head contractor). Sometimes a subcontractor can be liable to the ultimate customer under that Act. This reinforces the need for care in the sales process[4].

3 Solutions

3.1 These include:

3.1.1 It is still important for subcontractors to take care in respect of the ultimate customer. As well as potential liability such as Fair Trading Act liability there are still risks given the particular facts of each case, including of course liability to the head contractor.

3.1.2 It would be possible to belt and brace the arrangement by making sure, one way or another, that the ultimate customer acknowledges that it has no (or a limited) claim against the subcontractor. This can be done by a clause in the head contract, or by a notice (ideally expressly accepted in writing) from the subcontractor confirming

[2] Much of the judgment focuses on these important issues and the case restates the applicable principles: for a useful summary see S Todd in the tort update in *[2004] New Zealand Law Review 585*.
[3] Another type of tortious claim (negligent misrepresentation) was left open in the case although it probably would have to face the same hurdles noted above.
[4] For more detail, see our article at http://www.wigleylaw.com/TendersRFSCompetitivePurchasing.html.

same. Commercially however, that could be a hard sell for a subcontractor and in practice might only be considered in cases where particularly significant risk is foreseen. For more detail, including as to *Himalaya* and Contracts (Privity) Act clauses, see our Limitation of Liability and related Issues: Impact on Suppliers and Purchasers paper at http://www.wigleylaw.com/LimitationOfLiabilityAndRelatedIssues.html.

3.1.3 Generally, trying to exclude liability of the subcontractor to the ultimate customer in the contract between the head contractor and the subcontractor will not be effective. That is so, unless, as happened in the *Rolls-Royce* case, the ultimate customer saw the clause, but even then it's a risk. There is authority to the contrary but this is too risky to rely upon[5].

[5] Note however that there is authority to the contrary (see page 591 of the Todd paper) referred to above.