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# LIMITATION OF LIABILITY AND RELATED ISSUES: IMPACT ON SUPPLIERS & PURCHASERS FEBRUARY 2005 UPDATE

**PAPER ORIGINALLY PRESENTED IN 2002 TO NEW ZEALAND COMPUTER SOCIETY "THE LAW OF IT" SEMINARS, AND TO THE TECHNOLOGY LAW SOCIETY**

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One of the key issues (if not the key issue) in contracts is the limitation of a vendor's liability. This pivots around limitation of liability clauses, but there are other issues as well such as service levels and rebates, indemnities, legislative risk such as the Fair Trading Act and the Consumer Guarantees Act, international risk, and so on. We have updated and presented this paper at seminars several times, which was first presented to the New Zealand Computer Society and the Technology Law Society in 2002. This is our 2005 update.

Many a beautifully crafted limitation of liability clause fails simply because it is badly written, overridden by other parts of the agreement, overridden by statute, or steps have not been taken to make sure the clause is part of the agreement.

We will single out the commonplace exclusion of liability for indirect or consequential loss as a problem area. If English cases are followed, these clauses often don't do what's desired.

As well as covering limitation of liability clauses, this paper deals with entire agreement clauses, indemnities (including special issues around public sector indemnities), Fair Trading Act risk (which is a frequent and effective incursion into well drafted limitation clauses), and "back-to-back" risk situations. We'll also cover a win-win strategy: service levels with rebates (and similar structures). If these are well crafted, they can limit the supplier's liability yet still satisfy customer needs.

This note focuses on business-to-business risk but we'll touch on business-to-consumer risk too, including the implications of legislation such as the Consumer Guarantees Act. The impact of comparable legislation overseas, which can often impact on international business-to-business transactions, is also dealt with briefly.

Mechanisms for limiting contractual liability are just backstop measures. Both parties should always be looking at minimising risks in other ways (such as by minimising the risk of breaching commitments made in the first place). Where risk is high, particular care should be taken in dealing with liability clauses. But sometimes (such as in consumer transactions) the dollar risk is low and it may not be worth pursuing this too far.

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# 1 Executive Summary and Introduction

1.1 This is not a "them-against-us" story. Most private sector businesses and public sector agencies want to limit liability for many things they do. And, as we'll show, it's often better for customers to accept limited supplier liability than insist on unlimited liability. The alternative is often a pricy "gold-plated" offering that can be commercially hard to justify.

1.2 Many a beautifully crafted limitation of liability clause fails simply because it is badly written, overridden by other parts of the agreement, overridden by statute, or steps have not been taken to make sure the clause is part of the agreement.

1.3 Where an agreement is not physically signed, the safest course is to draw attention to the limitation and/or exclusion of liability, together with any other onerous or unusual terms. This will typically be relevant with on-line transactions or when standard terms need to be incorporated (for example, in a signed credit application).

1.4 We will single out the commonplace exclusion of liability for indirect or consequential loss as a problem area. If English cases are followed, many clauses used in New Zealand don't do what's desired.

1.5 As well as covering limitation of liability clauses, this note deals with entire agreement clauses, indemnities (including special issues around Crown indemnities), Fair Trading Act risk (which is a frequent and effective incursion on well drafted limitation clauses), and "back-to-back" risk situations. We'll also cover a win-win strategy: service levels with rebates (and similar structures). If these are well crafted, they can limit the supplier's liability yet still satisfy customer needs.

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1.7 Mechanisms for limiting contractual liability are just backstop measures. Both parties should always be looking at minimising risks in other ways (such as by minimising the risk of breaching commitments made in the first place). Where risk is high, particular care should be taken in dealing with liability clauses. But sometimes (such as in consumer transactions) the dollar risk is low and it may not be worth pursuing this too far.

1.8 This paper deals with complex issues, so it goes into some detail on the legal aspects.

## 2 Is it right that suppliers should be able to limit their liability?

2.1 Yes, and we suggest it is ultimately in the interests of both the supplier and purchaser to do so. However, that's not to say that it's always fairly implemented. There can be an imbalance.

2.2 A limitation of liability clause is a way of allocating risk. Without it, a supplier may have to goldplate its service to avoid exposure to risk, and so the cost of the service is likely to go up. Further, unlimited liability is likely to minimise innovation or "stretch" targets. Many customers, when faced with the choice, would prefer to take on additional risk in the event of a breach and reduce the cost of the service being provided and/or encourage the supplier to extend its service offering. In mission-critical situations however, the customer may need to take a gold-plated service (eg: by duplicating computer or communication systems) or require a higher level of liability to be undertaken by the supplier.

2.3 Our courts accept that limitation of liability clauses aren't necessarily one-sided and inherently bad. They can reflect the allocation of economic responsibility. See particularly *DHL v. Richmond* [1993] 3 NZLR 10.

2.4 Some suppliers will refuse to supply products or services without a reasonable level of liability limitation in place. For example, a multi-national might have no choice but to contract on the basis of limited liability under its head office-dictated policy. A purchaser may miss out on services it particularly wants if it is too inflexible and insists on having no limitation. A similar issue arises in relation to some of the broader indemnities sought by some parties.

2.5 There are also other ways that customers can achieve the desired outcome. Often, those ways can be better than the unsatisfactory task of suing for unliquidated damages through the Courts. They include:

2.5.1 The ultimate remedy of terminating the contract (even though that implicitly involves claims for unliquidated damages);

2.5.2 Commercial (and maybe PR) pressure;

2.5.3 Setting service levels, with rebates debited from the supplier's invoice where there is a performance failure. There could also be performance credits where the supplier exceeds the service level. Service level credits, which are a "carrot" to encourage the supplier to exceed set targets, can set better behaviours in place than a system that is based solely on penalties. Our article on SLAs generally (and in the telco sectors) deals with this in more detail.[1]

2.5.4 Insuring the risk. Sometimes there is real advantage in having insurance. We question however the true value of this in many situations. Insurance would not always cover the sort of risk that is involved (and suitable cover may well be too expensive for many parties anyway). Many technology and other contracts deal with insurance but, to us, they may add little value. Customers should check the type and extent of cover available if they wish to rely on insurance arrangements; and

2.5.5 Taking practical steps to avoid the risks (for example, maintaining access to source code and the supplier's personnel).

## 3 Limitation clauses don't always work

3.1 A limitation of liability clause won't always work, however well it is drafted. This means that the party being claimed against might have an unlimited exposure regardless of its efforts to restrict liability. There are several reasons for this, including:

3.1.1 While in theory the Courts now take a more neutral line on limitation clauses (see below), in practice a Court may try to find a way around the clause – especially if it thinks the party relying on the clause has acted particularly poorly or it sees an imbalance between the parties' bargaining positions. Further, it's not yet crystal clear how far the Courts will take a neutral approach to interpretation along the lines of *DHL v Richmond.*

3.1.2 There can be liability under the Fair Trading Act for misleading statements made in the sales process (even if those statements aren't incorporated into the final written contract itself).[2] Usually, a contractual limitation of liability will not be effective to overcome the statutory Fair Trading Act liability to pay compensation in these circumstances. This issue is a particularly important one in the Information and Communications Technology (ICT) sector especially in RFP and other competitive tender scenarios, and one which can unwittingly trip up a supplier.[3]

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[1] *Service Level Agreements – Are they worth the paper they are written on?* www.wigleylaw.com/ServiceLevelAgreements.html (for example in cases involving sales to SMEs), and *Telecommunication Service Level Agreements – Are they worth the paper they are written on?* http://www.wigleylaw.com/TelecommunicationServiceLevelAgreements.html

[2] This might happen too under the Contractual Remedies Act.

[3] See our article *Tenders, RFPs and Competitive Purchasing: Traps for Unwary Buyers and Sellers* www.wigleylaw.com/TendersRFSCompetitivePurchasing.html *May 2004 Update.* For a very good

3.1.3 Especially in ICT deals, the devil is in the detail. Problems like INCIS show how huge risk arises out of the specifications and scoping. A common problem is material, such as specifications, effectively overriding the nice limitation clause. Lawyers can't avoid getting into the detail, even though it can often be foreign and technical. It's nowhere near enough to only deal with the boilerplate. Yet that's what often happens. There's a good example of this in the related context of RFPs when we talk about *Pratt v PNCC in* our paper, *Tenders, RFPs and Competitive Purchasing: Traps for Unwary Buyers and Sellers: May 2004 Update*[4]. The Council was unexpectedly liable due to a clause slipped into the detail that overrode the standard restriction on liability/responsibility. What can happen with contracts is that the technical people, often using different language and concepts, can create responsibilities which are inconsistent with the limitation of liability clause in a way that creates heavier liability. These responsibilities may in fact not be capped by the limitation and create responsibilities that apply regardless.

3.1.4 The limitation clause might be great, but it hasn't been properly incorporated in the contract. In our experience this is a big problem especially in the on-line environment. We expand on this below.

3.2 Limitation of liability is generally more important in relation to the risk of systemic failure (e.g. Mercury Energy type of risk) than one-off risks. The latter type of claim is often settled without regard to the contract, but unlimited liability can sink a supplier where there's widespread liability. So, the limitation of liability clause can be critical. When setting up the limitation regime, suppliers should particularly have in mind widespread systemic risk, not just one-off risks. Often they don't do this, saying in effect "*We haven't been sued before so why should we bother now*". That, we suggest, is not enough reason to take a relaxed approach on contracting. For example, when the National Library had a fire causing $1.9m of loss, a supplier of batteries (said to have caused the fire) was sued. The supplier sold to a party 2 steps removed from the library and had no signed contract. It was lucky to escape $1.9m liability based on very small sales[5].

3.3 Generally, dollar risk is higher with business-to-business deals. So, often, a supplier is justified in taking a less strict line with consumer

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collection of the authorities, including cases where the limitation of liability is effective in a Fair Trading Act context, see *Gault on Commercial Law* at paras 9.36-9.37.

[4] *Tenders, RFPs and Competitive Purchasing: Traps for Unwary Buyers and Sellers: May 2004* www.wigleylaw.com/TendersRFSCompetitivePurchasingTrapsForUnwaryBuyer.html

[5] *A.G v Seven Electrical* [2004] 8 NZBLC 101,105, dealt with below in relation to incorporation of terms.

sales. Compulsory consumer legislation makes it harder to limit consumer liability anyway.

## 4 Interpretation of limitation and exclusion clauses

### 4.1 Introduction

4.2 Unlike earlier days, when Courts would interpret limitation of liability contracts aggressively against the supplier, the New Zealand Courts increasingly take a more neutral approach to interpretation. This, our Court of Appeal says, reflects the economic reality of risk allocation and contractual choice. The leading case of *DHL v. Richmond*[6] is a good example because it involves a multi-national's standard terms, which many would regard as being imposed unilaterally on the customer.

4.3 Richmond, the meat producer, sued because DHL lost valuable shipping documents. Standard international courier documentation was used (the sort of document that an administrative assistant often completes[7]). This included a provision limiting liability to $100. The fact that DHL is a multi-national, and traded on standard pre-printed documents, did not stop the Court of Appeal from interpreting the contract neutrally and ultimately holding that the limitation of liability worked.

4.4 In *DHL*, the Court of Appeal said:

4.4.1 "*In international commercial arrangements of this kind involving major commercial organisations, it would be unsafe to approach the interpretation of their contract on the footing that it was a product of unequal economic power or to regard standard terms and limitation provisions as somehow suspect and so give them a strained construction to protect the shipper. Such provisions are to be given their natural plain meaning read in the light of the contract as a whole. Only in that way will the reasonable expectations of the parties as expressed in the contract be fulfilled.*"

4.5 The Court would not read down the unqualified breadth of the exclusion clause as that would have involved rewriting the contract and transferring to DHL what was probably a commercial risk accepted by Richmond.

4.6 While the Court referred to international transactions, it's likely the same principles will be applied to any deals between larger entities. This may also happen in other New Zealand business-to-business transactions, given that legislation provides protection to those that need protecting

[6] *DHL v. Richmond* [1993] 3 NZLR 10. See also *Boat Park v Hutchinson* [1999] 2 NZLR 74.
[7] Which raises another question: whether the person signing a contract on behalf of the purchaser can legally bind the purchasing entity.

(eg: the Consumer Guarantees Act and the Fair Trading Act). But it remains arguable that, where there is a commercial imbalance (eg: a large corporate selling to a SME), the Court may take a more strident approach as against the supplier.

4.7 Despite the more neutral approach adopted by the Courts, any ambiguity will still be construed against the supplier.[8] Many limitation clauses that we've seen are at risk of failing due to:

4.7.1 loose wording; and

4.7.2 use of other wording in the same document or elsewhere which dilutes the effect of the limitation clause.

4.8 The Courts can latch on to poor wording or inconsistencies as a way to expand the supplier's liability. We give a good example below. Often clauses exclude liability for "consequential loss *including* loss of profit". This would apply to lost profit that is *also* defined as *consequential loss*. As we note below, most lost profit may in fact **not** be consequential loss. It's better to deal with loss of profit separately (eg: as part of a list of excluded damages).

4.9 **Exclusion clauses**

4.10 In earlier cases, the Courts took a more aggressive stance as against *exclusion* clauses (that is, clauses that totally exclude liability) compared with *limitation* clauses (ie: clauses that allow, but limit, liability). There are signs that the same line would not now be taken in New Zealand, although that is not yet clearly resolved.[9] It's therefore better to provide for some compensation (ie: use a *limitation* clause) rather than have total *exclusion* of liability. To overcome risk in this area, the compensation provided in the contract probably does not have to be much more than what is virtually a total exclusion of liability.

4.11 It's also likely that the doctrine of fundamental breach is no longer applicable (historically liability for this could not be limited), and the parties can exclude the supplier's liability for fundamental breach, deliberate breaches and other breaches that go to the core of the contract. However, it remains possible that in cases of total non-performance or totally different performance, the limitation/exclusion would not be enforced.[10]

## 5 Incorporation of limitation of liability in the agreement

[8] Burrows and Others *Law of Contract in New Zealand* (2nd Ed) para 7.3.1. Generally, where there's ambiguity, the Courts will look at the factual matrix, and will tend to apply a business commonsense interpretation in preference to a detailed syntactical and semantic analysis (*Boat Park v Hutchinson* [1999] 2 NZLR 74, 81)
[9] See Burrows text noted above at 214-215.
[10] See Burrows and Others at pages 222-223.

5.1 **Introduction:**

5.2 In giving advice, lawyers often seem to focus only on the wording of the limitation clause and other contract terms. They can overlook ensuring that the purchaser is actually bound by the terms in the first place. The fanciest limitation of liability clause can fail (and many do) simply because the supplier has not done enough to incorporate the provision in the contract.

5.3 For example, it's too risky - where there's high dollar exposure - just to cross-refer, in the signed document, to standard terms located elsewhere. Special attention should be drawn to the limitation of liability clause, particularly if it could be considered onerous or unusual.[11]. In a recent case Clear Communications was lucky that the Court accepted that its limitation of liability term was incorporated in the agreement.[12] It concluded that the limitation provision in that context was not a particularly onerous term, to which special attention had to be drawn. We're not sure that position will be accepted in all cases, despite the National Library case referred to above (*A.G v. Seven Electrical*) where it was held in those circumstances that the relevant clauses were not "onerous"[13].

5.4 **What happens if the limitation is in a document that's signed?**

5.5 In agreements negotiated and agreed on a one-off basis, it's unlikely the supplier would need to draw special attention to the limitation clause for it to be effective[14]. But the position is not so straightforward in other situations. The examples given in Burrows[15] include:

5.5.1 In one Canadian case, a car hire company, hiring out a car, could not rely "*…on an onerous clause on the back of the rental contract [signed by the customer] and in fine print which restricted the customer's insurance cover.*"

5.5.2 Likewise, in Australia, "*… a visitor to a go-kart track was not bound by a form containing an exclusion clause which he signed on entering, because he thought it was a marketing or registration form, there was limited opportunity to read it and none of the occupier's staff drew it to his attention.*"

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[11] *Thornton v Shoe Lane Parking Ltd* [1971] 2 QB 163 (CA)
[12] See our article *$4.6m Claim against Clear for Internet Service Failure: What can suppliers learn.* www.wigleylaw.com/46mClaimAgainstClearForInternetServiceFailure.html for further details and analysis.
[13] See *A.G v Seven Electrical* [2004] 8 NZBLC, pages 101, 511.
[14] See *Toll (FGCT) Pty Limited v. Alphapharm [2004] HCA 52.*
[15] At page 208.

5.6 The Burrows text concludes that New Zealand is likely to follow a similar path:

> *"Incorporation of an exclusion clause, only where there appears to be informed consent, is the appropriate and desirable rule."*[16]

5.7 That the signature of a document containing contract terms is strong evidence and legally powerful, appears from the November 2004 High Court of Australia decision in *Toll (FGCT) Pty Limited v. Alphapharm [2004] HCA 52*. There, the customer signed an application for credit terms which included contract terms. It was apparent that there were contract terms involved (and this was stated near where the person signed the document). That's enough to make the terms legally binding. It does not have to be demonstrated that the customer's representative actually read the terms, nor that particularly onerous terms were specifically referred to the customer. The High Court of Australia specifically referred to the Australian case noted above and, while it did not have to decide the point, probably would have taken a different position (similarly in relation to the Canadian car hire case).

5.8 The law is likely to be applied similarly in New Zealand, but it would remain prudent, where there are particularly onerous terms, for those to be specifically referred to even where the document is signed. As "click-accept" emerges as a way of entering contracts (this is a method which has inherent risk anyway), there is even more reason to do this as it does not automatically follow that the Courts will follow the same rules for click-accept as they do for hand written signatures.

5.9 **Terms coming into existence after contract concluded**

5.10 This can be a common situation in practice. For example, parties agree on the sale and purchase of goods on the telephone. Then a document (typically an invoice) comes later, which includes terms of trade. Of course the contract was concluded verbally. The terms come too late to be incorporated in the contract and so are not legally binding.

5.11 There is a special case however. There may be occasions where the *course of dealing* is such that the purchaser is deemed to have notice of the terms. The best example is where the vendor has issued invoices with the terms on the back. Some cases have decided that, where (a) there is adequate reference to the terms on the front of the series of invoices, and (b) "onerous" terms are referred to where relevant, the terms can be binding. But those situations are risky for vendors, and vendors certainly should not rely on the course of dealing argument.[17]

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[16] See Burrows at pp208-209.
[17] For more detail see Burrows at p206.

5.12 The National Library High Court decision mentioned above, *Attorney General v. Seven Electrical Limited (2004) 8 NZBLC 101,501* addressed this situation. Here there was no signed agreement, but there were terms on the back of the vendor's standard invoices, and the front of the invoice referred to the terms on the back. The Court held that there were at least 8 sales in the preceding 11 month period and that, coupled with 33 further purchases on later dates on identical invoices, this was enough for the terms to be incorporated in the contract. In the circumstances, the terms were not so onerous that they needed to be referred to expressly in a more direct way (that was because the limitations of liability were standard in the industry). Generally however, and particularly where there is significant risk involved for the vendor, this method of incorporating terms in a contract should not be replied upon. In this case the supplier of cheap batteries could have been liable for $1.9m.

5.13 **On-line trading**

5.14 Numerous deals, large and small, are now concluded on-line such as by exchange of emails or by purchase through a website. As a matter of principle, such on-line contracts will generally be enforceable under New Zealand law. The Electronic Transactions Act 2002 confirms what was the likely position anyway. In each case, the real issue is often around proof and evidence. For example, a "click-accept" acceptance of terms may not be enough to prove the purchaser is bound.

5.15 Where it is important for the supplier to limit liability (for example, due to high dollar risk) suppliers should still consider using handwritten agreements, not agreements signed on-line.[18] One of the difficulties with on-line contracts is proving that someone duly authorised on behalf of the purchasing entity has in fact "*signed*" the agreement (eg: when he or she "*click accepts*").

5.16 Robust technologies and methodologies such as Public Key Infrastructure are both (a) not being used in practice in respect of major commercial dealings between arms-length traders; and (b) still have their difficulties in terms of proving who exactly "*signed*". In particular, for Private Key Infrastructure, it is possible that the person purporting to sign as the purchaser, using a private key, is not in fact the named person (or, more importantly, the supplier may not be able to prove that in court). In practice, misuse of private keys is easy and common. For good overviews by PKI-sceptics, see J. K. Winn, *The Emperor's New Clothes: The Shocking Truth About Digital Signatures and Internet Commerce* (March 2001)[19] and R. Clarke, *The Fundamental Inadequacies of Conventional Public Key Infrastructure* .[20]

[18] For more information see our NZ Law Society 2002 Seminar paper, *Effective Transactions On-Line* www.wigleylaw.com/EffectiveTransactionsOnLineLiability.html
[19] www.totse.com/en/technology/cyberspace_the_new_frontier/162023.html (last visited 12 February 2004)
[20] www.anu.edu.au/people/Roger.Clarke/II/ECIS2001.html (last visited 12 February 2004)

5.17 See also the 2004 text by L. Brazell, *Electronic Signatures Law and Regulations*.

5.18 The Electronic Transactions Act 2002 makes little difference to this position for a number of reasons, particularly as the main focus of the legislation is upon statutory and regulatory requirements. Most of these limitations of liability issues are not governed by statute (save in respect of consumer protection legislation). Section 24 (the default provision which sets out when an on-line "signature" is valid) generally won't apply in practice with current technology.

5.19 There are solutions, such as an initial agreement by which the parties agree to trade subsequently by click-accept methods. That can work. Various on-line authentication systems will have similar strength.

## 6 Changing Terms including Limitation of Liability Clauses

6.1 A large vendor with multiple customers (and even smaller vendors) struggles in practice to get customers to sign up to new terms. A recent case (*Barton v. Air New Zealand*) shows a way that makes this easier. See our article on the case[21].

## 7 Services provided outside written contract

7.1 This is another way in which the limitation of liability provision can fail to cover a claim.

7.2 For example, a supplier might do one deal with a customer for which there are specific terms including a limitation of liability clause. The supplier goes on and does another deal without signing up the customer to similar terms. Unless it is expressly provided in the first agreement that the terms will apply to subsequent deals, the second and subsequent deals probably won't benefit from the limitation of liability contained in the first agreement.[22] The solution of course is to make it clear that the relevant terms (eg: limitation of liability) apply to all subsequent agreements. This should be made clear, for example, in standard terms of trade signed up as, say, part of a credit application form.

7.3 Sometimes the supply simply falls outside the scope of the written agreement in a way that gives the Court justification (and, of course, the Court may be looking for justification) to treat that supply as a separate obligation, which is therefore not subject to the limitation of liability clause. This could happen just as a matter of factual conclusion on the

[21] QC Battles Air New Zealand: Can a Supplier Unilaterally Change Contract Terms?: http://www.wigleylaw.com/QCBattlesAirNewZealand.html

[22] This assumes the course of dealing ground is not available. It usually isn't, and suppliers shouldn't risk it anyway.

evidence. A good example is *Catt v. ANZ Banking Group* (1993) 4 NZBLC 104, 035. The work being done fell outside a clause covering liability "*arising out of or in connection with the agreement*". In practice, this can often happen, especially in ICT work.

7.4 One very common scenario is that of the job starting without the contract signed up. Care is needed to ensure that when the contract is finally executed it also has retrospective effect if appropriate.

7.5 There could also be a *collateral contract*. A classic example is that of a verbal promise by a carpark attendant to look after a car, with the Court concluding that this promise was not covered by the exclusion clause in the parking ticket subsequently given to the plaintiff.[23]

## 8 Entire contract clauses

8.1 To try to overcome these problems, entire contract clauses are often included in agreements.[24] As an aside we note that these clauses are often used without reflection, given that they have the potential effect of excluding terms, which should otherwise be incorporated or implied for perfectly desirable reasons.

8.2 Entire contract clauses will not always work to exclude collateral contracts and the like. Firstly, as a matter of interpretation and evidence, they may not be wide enough in their wording to cover the circumstances. Secondly, particularly where agreements have not been fully negotiated nor is there equal bargaining strength, the Court may conclude that the entire contract clause should not be enforced.[25]

8.3 This approach flows from section 4(1) of the Contractual Remedies Act 1979 which deals with contract provisions purporting to preclude Courts from enquiring about pre-contract statements, etc. It allows the Court to look beyond a "no reliance" provision and an entire contract clause, "*unless the Court considers that it is fair and reasonable that the provision should be conclusive between the parties, having regard to all the circumstances of the case …*".

## 9 Pre-Contract negotiations

9.1 To overcome the risk of being bound by verbal representations or collateral warranties made during negotiations, parties will often seek to insert a "*no reliance*" clause. This will state the parties are not relying

[23] See Burrows at pp209-210.
[24] For a useful article, in an ICT context, on entire agreement clauses see "*Entire Agreement Clauses Excluding Liability for Pre-contract Statements*" by D. Blunt QC and K. Houghton in Computers & Law (2001) Volume 12 Issue 1 p31.
[25] For a summary of the law relating to collateral contracts and entire contract clauses, see *The Association of Community Laboratories and Others v. Ministry of Health* CP 278/01 (Wellington Registry); 6/11/02; Master Gendall. See also *Richards v. Murgatroyd* CA 30/00, 21 August 2000.

on any representation, agreement, term etc that are not set out in the agreement. The Court cannot override the *no-reliance* clause where it is fair and reasonable that the provision should be conclusive between the parties having regard to all the circumstances of the case.[26] Section 5 of the Contractual Remedies Act deals with remedies relating to misrepresentation, repudiation or breach of contract. The Court of Appeal has confirmed that, in relation to business-to-business deals negotiated at arms length (and perhaps with separate legal advice) the parties should have some certainty. Therefore section 4 of the Contractual Remedies Act should not be invoked to overcome a *no-reliance* clause in those circumstances.[27]

9.2 There is some debate about the ability to override sections 4 and 5 of the Contractual Remedies Act in practice.[28] But in any event, a no reliance clause is unlikely to override Fair Trading Act liability, which is statutory. That Act can lead to the supplier being liable without limitation despite a limitation of liability clause and a no-reliance clause.[29] So even where a *no-reliance* clause would be enforced, suppliers should still be aware of potential risk under the Fair Trading Act (and take care to make statements in negotiations and marketing which are sustainable).

## 10 What should a good limitation of liability clause contain?

### 10.1 Introduction

10.2 There are many different approaches so we'll start with a good "belt and braces" structure. This structure recognises that simple limitation of liability clauses (eg: with one type of limitation) won't always work. So it combines several "barriers" into one.

### 10.3 Compensation

10.4 In this example the first part of the clause sets out the primary regime for compensation. Very often this will provide full liability only for "direct" loss such as the cost of repairing or replacing problematic equipment. We think it's often better to say what liability there will be, then exclude the rest (rather than just exclude consequential loss claims).

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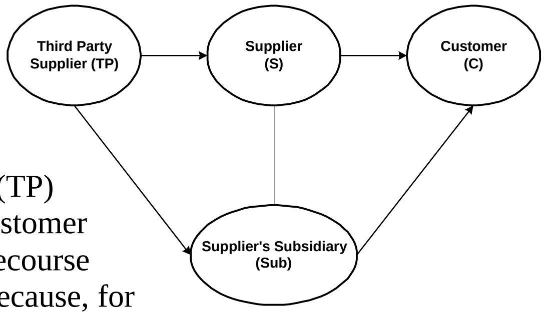
[26] Section 4 of the Contractual Remedies Act 1979 sets out the various factors.
[27] *Brownlie v. Shotover Mining Ltd* CA 187/87, 21 February 1992.
[28] See for example Burrows at pp226-230.
[29] For more detail, see our article *Tenders, RFPs and Competitive Purchasing: Traps for Unwary Buyers and Sellers* www.wigleylaw.com/TendersRFSCompetitivePurchasing.html *May 2004 Update*.

## 10.5 Protection of Other Parties, to the Benefit of the Supplier

10.6 This bit gets quite complicated. See the diagram. A good clause should protect parties other than the supplier itself. It's very common for a supplier (S) to be reliant upon third party suppliers (TP) when supplying services to the customer (C). S may have no contractual recourse against TP if TP's service fails (because, for example, TP's liability is excluded). TP may well seek to limit or exclude its liability to S (and C) in relation to any failure of its products or services impacting on C. This means S should take steps to limit its own exposure to C in relation to that sort of event occurring. The parties may all need to avoid liability risk to clients of C too – so a chain of liability can arise and needs to be managed each step of the way. This multiple-party risk is common in ICT and other sectors. So a so-called *Satterthwaite* or *Himalaya* clause bolsters the supplier's protection. This is a clause that S puts in its contract with C to preclude claims by C against third parties such as the supplier to C and also S's subsidiaries, employees, etc.




10.7 This sort of clause also deals with the risk faced by S that C could try to sue TP direct in negligence, for example. TP's contract with S may allow recourse by TP in those situations against S (and S should try to avoid this). Shipping cases establish that clauses cutting out C's claims again TP are effective.

10.8 The Contracts (Privity) Act has a role too, as a means of providing enforceable protection to third parties and in fact that could be a preferable approach to using a Himalaya type of clause. A good clause based on the Contracts (Privity) Act will give the benefit of the limitation clause to third party providers. It should also cover the situation where S has a subsidiary (Sub) that provides services to C.

10.9 The Third Party (TP) supplier may also seek to ensure – one way or another – that its customer's customer (C) cannot sue TP. Upstream internet service providers, for example, typically require downstream ISPs to insert a clause that – in effect – exonerates TP from liability to the end user customer, C.

10.10 In 2004 our Court of Appeal clarified the law in this area in *Royce v. Carter Holt*. For more detail on this topic of subcontractors' liability see our article, *Are Subcontractors liable to the Head Contractor's Ultimate Customer? A Rolls-Royce Answer:* www.wigleylaw.com/Aresubcontractorsliabletotheheadcontractorsultimat.html.

10.11 **Non-contract liability**

10.12 There can of course be liability outside the contract itself, particularly concurrent liability for negligence.[30] Therefore, a well-drafted limitation of liability provision should extend to other causes of action including negligence. Many limitation of liability provisions specifically refer to torts and negligence. This is not essential[31] (and can be commercially unpalatable). A carefully drafted clause could successfully exclude liability for negligence yet not refer to it specifically. But suppliers doing this should be especially careful. The safest course is to expressly refer to tort (and, maybe, equity).

10.13 **Backstop Maximum Liability**

10.14 Generally, supply contracts should also contain a maximum liability. What in effect the supplier says is:

> "*We are only liable for compensation under clause ABC. We are not liable for anything else. However, if that exclusion of liability doesn't work, then in any event we are only liable for a specified amount for each incident. And our maximum liability throughout is $Y anyway.*"

10.15 The supplier could also have "backstop" liability based upon one or more of, for example:

10.15.1 $XK per event or related events with a total of $YK in any 12 month period;

10.15.2 a total value for the whole contract period; or

10.15.3 some other fixed or variable method.

10.16 The amount of this "backstop" liability is frequently debated between supplier and purchaser in an openly negotiated agreement.

10.17 **Excluding consequential loss liability: Does it work?**

10.18 Our example of a comprehensive clause deliberately doesn't include the commonly used "no liability for consequential loss" approach. Many clauses seek to limit liability by excluding liability for consequential loss. Often words like "indirect or consequential loss" are used. This is intended to cover big ticket items such as loss of profit. In most

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[30] Fiduciary and equitable duties are other risks, especially in JVs and the like. See our article *Getting closer and building positive relationships: Working together in Commerce & Technology* www.wigleylaw.com/GettingCloserAndBuildingPositiveRelationships.html and the latter case *Chirnside v Day [2004] 3 NZLR 637].*

[31] *George Mitchell v. Finney Lock Seeds* [1983] 2 AC 803 and *Kaniere Gold v. Dunedin Engineering* (1985) 1 NZBLC 99,024.

technology and other contracts, lost profit, additional operating costs etc, are where the greatest losses lie. Successfully excluding this liability greatly minimises the supplier's exposure. For reasons developed below, however, these consequential loss clauses are potentially problematic. There is much to be said for a different or a cleaner approach.

10.19 A key potential risk for consequential loss clauses is that New Zealand Courts might apply a recent line of English Court of Appeal cases that restrictively interpret consequential loss clauses.[32] There's Australian authority to similar effect.[33]

10.20 To understand the issues it is necessary to walk through the detail. In the English cases, the Courts interpreted consequential loss clauses by applying the long-standing authority on remoteness of damage, *Hadley v. Baxendale*.[34] That case divided damages flowing from breach into two limbs. The first limb is based upon damages which "*….naturally, ie: according to the usual course of things…*" flow from the breach. Judgment would be given for those damages even if the defendant knew nothing specifically about the loss to be incurred. The second limb is based upon other damages (ie: those that don't naturally flow from the breach). In that instance, the defendant would generally only be liable if it had actual knowledge of the prospect that such loss would flow from the breach.[35]

10.21 What the English Courts said is that a typical "consequential loss" clause only applied to the second limb, not the first limb. The difficulty is that, in most commercial situations, lost profit and the like naturally flows from the breach and so falls within the first limb. The customer's profit element is a natural component of the deal. Therefore in most cases, a consequential loss clause (which is said to be 2$^{nd}$ limb loss) would not be effective to exclude liability for key areas such as lost profit. As one commentator notes:[36]

> "*It follows from this decision that, if one of the parties wishes to exclude liability for loss of profits that arise in the other's normal*

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[32] Eg: *British Sugar v NEI Power Projects* 87 BLR 42, *Pegler v. Wang* [2000] BLR 218 and *Hotel Services v. Hilton* [2000] 1 All ER (Comm) 750. See also Chapter 14 in *Chitty on Contract* (28$^{th}$ edition) and 2003 Supplement. There are useful summaries in two articles in the Computers & Law journal, namely M. Davis and T. Strong, *Exclusion and Limitation Clauses in IT Contracts* Vol 11, Issue 1 p29 and R. Harrison, *Consequential Loss and IT Lawyers*, Vol 9 Issue 3 p28. The principles referred to in this article are based upon common law and survive independently of the UK Unfair Contracts Terms Act, which has potent effect in that jurisdiction.

[33] *GEC Alsthom v. City of Sunshine*.

[34] (1854) 9 Exch 341, 354.

[35] This over-simplifies the analysis. There are numerous cases since *Hadley v. Baxendale* which further refine the position and suggest that the 2 limb analysis is outmoded (see in particular *Stirling v. Paulgrain* [1980] 2 NZLR 402). However, the case is still frequently cited and applied, and remains relevant in a New Zealand context (and in the context of this paper) despite *Stirling*.

[36] See the Davis and Strong article referred to above, at p30.

> *course of business, clear words must be used. An exclusion of "indirect, special or consequential loss" will be ineffective to exclude such liability.*"

10.22 English law will only change if the House of Lords overrules the clear Court of Appeal authority. In *Caledonian North Sea v. British Telecommunications* [2002] UKHL 4, the House of Lords expressly reserved the point for later judgment.

10.23 In 2004, these English Court of Appeal cases came within the New Zealand Court of Appeal's radar, but no final decision has been made. In *Rolls-Royce v. Carter Holt Harvey*[37] our Court of Appeal briefly considered a clause, the material parts of which stated that the supplier would not be liable for:

> "*… any indirect or consequential loss suffered or incurred by [the customers] including any loss of use, revenue or profit …*"

10.24 Decision as to whether the English laws apply was left to another time. For background details on this case, see our article: *Are Subcontractors liable to the Head Contractor's Ultimate Customer? A Rolls-Royce Answer* at: www.wigleylaw.com/Aresubcontractorsliabletotheheadcontractorsultimat.html.

10.25 The Court of Appeal only outlined the competing arguments, as to whether or not the New Zealand Courts should follow the English Court of Appeal decisions.

10.26 We frequently see clauses that say that liability is excluded for consequential loss, **including** loss of profit etc. Express reference to lost profit and the like doesn't help in that context. Its identification in this way only includes lost profit that was consequential loss in the first place (ie: within the second limb). As mentioned above, most loss of profit will be within the first limb.

10.27 If these English cases are applied, many consequential loss clauses we see in New Zealand would fail to do what's intended. It is possible to draft them better. This is, after all, a drafting rather than a substantive legal issue. Suppliers could tailor clauses to the particular circumstances so they are more likely to be effective in relation to first limb damages (for example by defining what sort of loss is excluded). This may be desirable anyway for unique circumstances (or situations where lost profit is not at stake, such as for public sector customers). Generally it's probably best to avoid these clauses. But at least have a backstop maximum protection in any event.

[37] CA 259/02, 23 June 2004.

10.28 It's quite possible that the New Zealand Courts won't follow the English authorities (given the more neutral approach in cases such as *DHL*). Moreover, English cases subsequent to *British Sugar* relax the rigour of that decision. *Hotel Services* notes the situations are fact-intensive (ie: each depends on its own facts). But unless the supplier is comfortable about risking it, it's best to tighten drafting, to ditch consequential loss clauses or add other mechanisms.

10.29 Even if the New Zealand Courts don't follow the English cases, there is still an issue where the line is drawn (and "consequential loss" may still not include most types of lost profit for example). For good analyses of that issue, and the practical complexities, see *Hotel Services v. Hilton* [2000] 1 All ER (Comm) 750 and the High Court case referred to in that judgment, *BHP v. British Steel* [1999] 2 All ER (Comm) 544.

## 11 Service levels and rebates

11.1 If service levels and rebates are utilised (or similar vehicles such as liquidated damages clauses), one option is to make those rebates the only remedy for breach (other than termination). It's important to exclude other liability (and have backstop maximum liability in any event). As our articles on SLAs note, careful drafting of SLAs is essential[38].

11.2 SLAs with rebates (or similar regimes such as liquidated damages provisions) potentially offer a great "win-win" solution. A customer will often be happy with just having an effective rebate regime that operates instead of a general damages claim. This customer may want to make sure the supplier has "skin in the game". This is because payment of rebates is an automatic and simple process (in this way, it is similar to liquidated damages in a building contract). However, the dollars provided in typical rebate clauses are very small. They're almost always much smaller than the total potential liability if damages are at large. SLA/rebates can also be a good marketing strategy for suppliers. A real benefit for the supplier is that, as well as making an up front commitment to the customer which applies when there is a breach (a value-add), it can also considerably limit its exposure where there is a breach. In this way the rebate is like a liquidated damages clause (ie: a *genuine pre-estimate of damages*). It is enforceable and can operate as part of the overall limitation of liability regime.[39] But care is needed.

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[38] See our articles, *Telecommunication Service Levels – Are they worth the paper they are written on?* www.wigleylaw.com/TelecommunicationServiceLevelAgreements.html, *Service Level Agreements - Are they worth the paper they are written on?* www.wigleylaw.com/ServiceLevelAgreements.html and *$4.6m claim against Clear for internet service failure, what can suppliers learn?* www.wigleylaw.com/46mClaimAgainstClearForInternetServiceFailure.html

[39] For more information on liquidated damages, see Burrows at p800, and R. Stephens, *Service Credits and Penalties* Computers & Law, January 2003, page 37. The latter notes the possible – but unlikely – argument that having too low a rebate/credit could be a penalty (the liquidated damages/penalty rules are primarily aimed at situations where the liquidated damages/credits are too high)

11.3 SLAs can be difficult to draft. A very high proportion that we see are defective, exposing the supplier to far too great a risk (e.g. to pay the rebate and still be at risk of being sued for breach) or giving the purchaser nothing to latch onto by way of remedy. This is an area where extreme care is needed. A strong understanding of the underlying commercial and technical issues is needed.

## 12 Indemnities

12.1 For more detail on public and private sector indemnities, see our paper *Contractual Indemnities: Public & Private Sector Implications* where we summarise some of the details[40].

12.2 A key purpose of indemnities in a commercial contract is to provide another avenue for making the supplier liable in addition to or instead of the remedies (such as termination, damages, etc.), which flow from breach of contract. Normal breach of contract principles involve the breach of a *primary* commitment (namely the failure to meet a contractual commitment), with *secondary* rights flowing from that breach (which are analysed in terms of causation and quantum). These are typically damages.[41] Very often, even a highly complex commercial agreement does not specify how the *secondary* rights are determined. Frequently these issues (made up mainly of causation and quantum) are left to the common law to determine.[42]

12.3 Often *boundaries* are placed around these *secondary* rights. So, for example, a typical *boundary* in a limitation of liability clauses is a cap on liability, or a statement that consequential loss can't be claimed. Within those *boundaries* however, common law damages rights generally apply.

12.4 Indemnities on the other hand are *primary* obligations. An indemnity can, for example, require the supplier to pay money to the customer on the happening of certain events (typically, by reimbursing the customer for loss incurred because the supplier has failed to meet another primary contractual obligation). They are conceptually different but often cover the same territory. Importantly, they involve payment as a *primary* step, not as a *secondary* step.

12.5 Depending on how an indemnity is drafted (after all the parties can choose its overall structure and effect), both approaches often lead to the same result. For example, to succeed under an indemnity clause, the customer will still often have to establish causation and quantum to the

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[40] See our paper *Contractual Indemnities: Public & Private Sector Implications* www.wigleylaw.com/ContractualIndemnities.html
[41] There may also be Contractual Remedies Act rights.
[42] And maybe, to the Contractual Remedies Act as well.

same level of proof, and following the same tests, as they would have to do when relying upon secondary common law rights.[43]

12.6 But that all depends upon how the parties choose to frame their indemnity. This is all a matter of contract. The indemnity clause could be widely framed to cover all sorts of loss including loss which has not been caused, or contributed to, by the supplier. On the other hand it could be much more restricted. Additionally the rights may well be subject to the cap in the limitation of liability clause. Without that, the cap may be largely ineffective at limiting a party's liability in the way intended, although this again depends on the scope of the indemnity.

12.7 Customers often fight hard to have indemnities included and yet they may already have the same rights by way of breach of contract remedies. It is not always clear how fighting for those rights advances the customer's interests. But again it all depends on the circumstances and type of indemnity sought.

12.8 The rights to indemnity can include entitlement to full reimbursement of legal costs although it would be prudent for the customer to set this out explicitly rather than leaving it for the courts to construe from less specific indemnity wording.

12.9 One of the few good summaries on indemnities, in a commercial contract context, is in McGuiness, *The Law of Guarantee* (2nd ed.) at pages 615-631). At page 618:

> *"Although there is a similarity in their respective practical consequence, a right to be indemnified is not the same as a right to recover damages. A right to recover damages is a legal right in favour of a plaintiff to be compensated by the defendant for injuries recognised at law which were suffered by the plaintiff as a result of the wrongful conduct of the defendant. A right of indemnity may exist where the plaintiff has suffered no injury at the hands of the person who is obliged to indemnify, and even where the wrong giving rise to the claim for indemnity was arising from some natural or other impersonal hazard committed by some third party, or where no wrong has been committed by any person but the indemnifier is nonetheless obliged to make good a loss which has been suffered by the claimant. Thus a right to recover the damages occasioned by breach of contract is the converse of a contractual right to an indemnity. Where a contractual right of indemnity exists, the right to indemnity constitutes a term of the contract and forms part of the contract between the parties. A right to damages for breach of contract, on the other hand, arises as a consequence of the breach of the original bargain which the parties made. A right to recover damages for breach of contract is not part of a contract;*

[43] I've not found authority to that effect but it follows basic remedies principles. So this point is subject to the possibility that there will be authority contrary to "basic principles" analysis. Note that Hughes and Sharp in their Computer Contracts text at para 1.520 consider, without giving reasons, that sums recoverable under an indemnity clause won't necessarily be limited by common law remoteness and other principles.

*it is an incident which the law attaches to a breach of contract, rather than a provision of the contract itself."*

## 13 Intellectual Property Indemnities

13.1 Typically, the parties to a contract agree that indemnities should be limited to the scope of the limitation of liability provision. Some types of liability however are often excluded from that cap. This includes, particularly, intellectual property and – often – breach of a confidentiality commitment. It is generally accepted that if a party breaches such an IP owners' rights or the other party's confidentiality, it should fully protect the other contracting party against any claims that arise as a result. This is because of the potentially colossal implications of such breaches on the business of the affected party. It is recognised that the enforcement of IP rights and protection of confidential information is uniquely within the hands of the party with the closest connection with it. Therefore it is often appropriate for there to be unlimited liability in those areas.

13.2 The whole area of IP, IP indemnities, etc is increasingly important and will be the subject of a later paper.

## 14 Indemnities and The Crown

14.1 These are covered by the new Crown Entities and related legislation. See our paper on indemnities *Contractual Indemnities: Public & Private Sector Implications* for more detail[44].

## 15 Consumer Guarantees Act

15.1 Of course, where the goods and services might come within the Consumer Guarantees Act, suppliers to businesses should contract out under section 43(2). Contracting out must be *in writing*.[45] Contracting out *in writing* can include on-line "*writing*"[46] by the indirect route of The Electronic Transactions Act 2002. But care is needed.

15.2 While suppliers can't contract out in relation to consumer sales, there are steps that can be taken to minimise liability including by framing the description of the goods or services in a way which does not exceed what they are capable of achieving, and also by identifying specific risks. This may be effective depending on the circumstances, although

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[44] *Contractual Indemnities: Public & Private Sector Implications* www.wigleylaw.com/ContractualIndemnities.html

[45] Or, if this is not possible because the supplier is unaware of the consumer's acceptance at the time of the acceptance, then the terms of the service must be clearly displayed in every place of the supplier's business. For more detail see K. Tokeley *Consumer Law in New Zealand* (2000) at page 140.

[46] The definition of "writing" in the Interpretation Act 1999, as amended by the Electronic Transactions Act 2002, means, in effect, hard copy. The Electronic Transactions Act allow electronic solutions, but care is needed.

an upfront approach would have to be taken to meet requirements such as section 7(1) of the Consumer Guarantees Act.

## 16 Back-to-Back Risk

16.1 In their dealings with customers, suppliers can try to replicate rights and liabilities as between the supplier and its upstream supplier. In practice this can be difficult. Often it's a valid commercial decision to make a greater commitment to the customer than can be recouped from the subcontractor if there is a default. But it should be a calculated decision and the supplier should first carefully consider the likelihood of the subcontractor defaulting and the likely consequences of it doing so.

## 17 International Risk

17.1 See our paper, *Exporting Technology: Reducing Legal and Dollar Risk*, for more detail[47]. Most jurisdictions will allow a limitation of liability clause (and comparable provisions) to be governed by the law chosen by the parties to the contract. This is subject however to the application of consumer protection and other national legislation, which can often have a potent effect. In some other countries, the effect can extend well beyond consumer transactions such as in relation to our Consumer Guarantees Act.

17.2 Two examples illustrate the point. Australia has wide-ranging consumer protection legislation in its Trade Practices Act. The Act extends way beyond the ambit of our Consumer Guarantees Act. Very often in business-to-business transactions in Australia, there can be unlimited liability (including for "consequential" loss such as loss of profit, etc.) unless the businesses that are contracting expressly contract out of that Act, using the detailed wording typically used in Australian business-to-business contracts. The sort of wording we would use here in New Zealand to contract out of the Consumer Guarantees Act won't do the trick under the comparable legislation in Australia.

17.3 Another example is UK's Unfair Contract Terms Act, which again can create mayhem for suppliers in a business-to-business context, and has been the source of much ICT litigation (the leading *St Albans v. ICL*[48] decision is an example).

17.4 While ideally legal advice would be obtained from the offshore jurisdiction in each instance, sometimes that is uneconomic and impractical. Suppliers may choose to take the risk. International suppliers may choose to apply foreign law as the law of the contract. Of course regard has to be had to the principles in the other jurisdiction.

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[47] *Exporting Technology: Reducing Legal and Dollar Risk* www.wigleylaw.com/ExportingTechnologyReducingLegalAndDollarRisk.html

[48] [1996] 4 All ER 481.

For example, Californian law is often chosen. The approach of the courts overseas to limitation of liability can differ considerably from New Zealand's, as is demonstrated by the bold writing invariably used in limitation clauses in the USA.

## 18 Extra-Contractual Liability for Statements

18.1 Essentially, "extra-contractual" risk arises from a situation where a party may become liable for statements it has made, but that are not contained in the final contract that is entered into. This is a significant risk area where exposure can be reduced through careful preparation and presentation. For example:

18.1.1 While not clear-cut, if the supplier qualifies its statement at the point where the statement is made, that may reduce or eliminate s.9 Fair Trading Act risk[49]; and

18.1.2 *Hedley Byrne* liability for negligent misstatement can be eliminated by adding a disclaimer to the statement made. The House of Lords so held in *Hedley Byrne* itself (indeed, the Bank making the statement in that case was held not to be liable in view of a disclaimer).

## 19 Conclusion

19.1 Limitation of liability clauses should only be regarded as a backstop measure which won't always work. Many are badly drafted and won't be effective. Particular care is needed around compulsory legislation such as the Fair Trading Act and the Consumer Guarantees Act. Suppliers and customers, particularly where risk is sizeable, should address each situation on a case by case basis. Watch out for unexpected fishhooks in the detail such as the specifications.

19.2 And do we really need to have the endless debates we have about indemnities when there are other ways of skinning the cat?

[49] See our paper on RFPs which expands on these issues. *Tenders, RFPs and Competitive Purchasing: Traps for Unwary Buyers and Sellers* www.wigleylaw.com/TendersRFSCompetitivePurchasing.html

Wigley & Company is a specialist technology (including IT and telecommunications), procurement and marketing law firm founded 11 years ago. With broad experience in acting for both vendors and purchasers, Wigley & Company understands the issues on "both sides of the fence", and so assists its clients in achieving win-win outcomes.

While the firm acts extensively in the commercial sector, it also has a large public sector agency client base, and understands the unique needs of the public sector. While mostly we work for large organisations, we also act for SMEs.

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