

contract management

IN PRACTICE

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Insuring against liability — the importance of a thorough risk assessment as part of the contracting process

Andy Evans

Insurance issue

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While involved in a negotiation recently, I was surprised by the audacity of a comment made by the lead negotiator of the other party when he stated: 'I know we are getting married soon, but we should also be prepared for the divorce as well.'

On reflection, it was a fairly pragmatic statement that the parties involved should conduct a thorough assessment of what they proposed to agree to and on outcomes if the relationship was to come to a premature end.

As part of any contracting process, it is expected that a thorough assessment be made of any potential mishaps and the impact that this may have on the benefits to be received from entering into a contractual relationship. This, in essence, is the very nature of conducting a risk assessment and determining whether the advantages outweigh the disadvantages and, therefore, whether a party will enter into contractual relations with another party. Whether done on a formal or informal basis, this is generally understood to be a fundamental requirement of agreeing to contract with any party.

A thorough risk assessment should address at least the following two key issues.

1. Performance risk — what is the likelihood of the other party being able to perform what they have agreed to perform?
2. Liability risk — if either party does not perform, what will be the potential liability (of either party) and how can I provide for this in contracting with the other party?

As will be shown, while most parties generally understand and provide for performance risk as part of a contract, liability risk is often given minimal attention and its components are invariably misunderstood.

Performance risk

Performance risk requires an assessment of whether a party will be able to perform its end of the bargain.

For a purchaser of goods and services, this generally means determining whether the supplier or provider has the appropriate resources, skills, competence and ability to supply or provide what it is committing to supply or provide. Other elements, such as the supplier's ability to deal with defective goods, provide after-sale services and coordinate transportation and delivery, will also be critical questions.

Editorial Panel



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For a supplier of goods and services, this generally means determining whether the purchaser has a credit history and adequate finance to pay for the goods or services supplied or provided. Other factors will also be considered, such as the purchaser's ability to actually receive the goods and services and integrate them into the business effectively.

Necessarily, a great amount of time and detail is spent on assessing the performance risk that a party will be subject to; this is in part due to a party's key focus for entering a transaction being the requirement to satisfy an immediate need.

Unfortunately, the amount of time spent on dealing with performance risk is often to the detriment of the amount of time spent on assessing an equally important risk — liability risk.

Liability risk

Liability risk requires assessment of who will assume responsibility for non-compliance with the contract and how this responsibility will be provided for, especially in cases where such non-compliance results in the termination of a contract.

While succession planning and change management have improved in modern business practice to ensure that business continuity is dealt with in cases of non-performance, they are invariably done so at great expense because a party has not turned its mind to dealing with the non-compliance that has resulted in the termination of a contract.

Without wanting to advocate the use of lawyers (of which I am one), some assistance should be sought in adequately providing for liability risk in

- understanding how a liability will be met — that is, what measures are put in place to satisfy the (potential) liability (the insurance issue).

While these two questions are often dealt with as part of risk assessment, often there is not a true understanding of the need to deal with them in tandem and what impact the two different questions have on each other.

Linking liability and insurance

Determining who will be liable for any loss or damage caused or suffered will be impacted upon by a number of factors, including the relative bargaining power of the parties, the reputation of a party, the price to be paid, the corresponding insurance coverage, the availability of competitors to provide the goods or services and a range of other factors.

While a number of the issues referred to above may dictate the answer to the liability issue, this should not result in parties turning a blind eye to it or seeing it as a trivial matter. Invariably, when a party starts to exhibit an inability to perform, this provision, along with the applicable termination provisions, will be the first thing a party refers to and the first thing that a party wishes it actually assessed thoroughly when drafting the contract.

It is important that parties have some starting point to understand the actual loss or damage that may be caused or suffered and the rights a party would have at law to recover that loss or damage.

Unless agreed otherwise between the parties in contract, a party will generally be liable for loss or damage caused to

... some assistance should be sought in adequately providing for liability risk in any contractual arrangement.

any contractual arrangement. This will require dealing with the following issues:

- determining who will be liable for any loss or damage caused or suffered (the liability issue); and

another party where that party, by its acts or omissions, directly or indirectly causes loss or damage to another party that was reasonably foreseeable and not too remote. This is generally referred to as the 'common law' position.

Once this is understood, it is incumbent upon a party to understand what level of liability it can accommodate and what steps it needs to take to minimise a potential liability. While it would be ideal to exist in an 'all care, no responsibility' environment, whereby liability could be waived or non-existent, the reality is that unless a party has enviable bargaining power, it will be required to carry some liability risk.

It is here that parties need to turn their minds to understanding how the ability to satisfy a liability may be met. In the unlikely case that a party carries, or wishes to rely upon, large cash reserves to satisfy liabilities, it is likely that a party will be looking to its insurance policies to cover liabilities. Therefore, it is important to align a potential liability with the ability to accommodate that liability.

Whether a party can afford to carry and accommodate a certain potential liability, by insurance coverage or otherwise, is an issue that should be addressed in the pre-contract stage, not once the contract has already commenced. Necessarily, this will require a party to look at the liability issue and the insurance issue in tandem to understand what liability risk it may have.

Too often, parties do not link the two prior to entering a contract and either end up not having appropriate insurance to cover a liability (and then having to self-fund) or, alternatively, from the perspective of a party seeking to recover a liability, they have accepted a liability regime that greatly excludes the other party's liability such that they are not entitled to recover any form of liability, regardless of whether the other party has insurance coverage that would satisfy the loss or damage caused.

Conclusion

Prior to entering into any contractual arrangement, it is important that a party conducts a thorough risk assessment to identify whether it will be receiving the benefit of the arrangement that it believes it will be obtaining, and also to understand what potential liabilities it may be exposed to if the contract does not continue as planned. With the breakdown of any relationship comes the requirement to satisfy the other party to some extent, and it is better to have considered such outcomes prior to the commencement of the relationship. ●



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IACCM commercial viewpoint

BY THE INTERNATIONAL ASSOCIATION FOR CONTRACT AND COMMERCIAL MANAGEMENT (IACCM)

Contingent liabilities: rebalancing of negotiator power?

Tim Cummins IACCM

Contractual liability and indemnity clauses have long been a source of contention.¹ Negotiators have wrestled with establishing a fair balance of risk and reward in determining both the causes and consequences of liability.

For many years, in most industries, the debate centred around the monetary limit for damages (frequently set at levels such as the purchase or project price, or even a percentage thereof) or whether such damages were per event or cumulative.

When it came to insurance for these potential losses, many large companies decided to self-insure. Others obtained third-party insurance, but generally predicated on their standard contract liability and indemnity provisions. A fact little known to many buyers was that negotiated exceptions to the standard

clause could often be outside the parameters of the insurance policy — and therefore in many cases of dubious value or enforceability.

Recently, the growth in buyer power (especially in large corporations and the public sector) has made it fashionable to craft evermore onerous liability provisions — unlimited damages and consequential loss are two of the more extreme, but increasingly common, provisions. Hit too often by failed projects, customers have sought methods to encourage supplier performance (often ignoring the fact that the inadequacy of their own requirement definition or lack of professionally competent project and contract governance were significant contributors to the failure).

One impact has been an increase in confrontation and lead times in negotiating agreements. Another has been a windfall for law firms, especially the third-party advisers in major systems integration, outsourcing and 'partnership' agreements. An aspect until now largely ignored has been the effect on insurance.

Briefly, as policy rates soared in the wake of 9/11, there seemed to be a slight lull in buyer demands and their success in driving more onerous terms. But that respite was temporary and most industries have seen a resurgence in buyer pressure. Yet to what extent are non-standard liabilities reflected in insurance coverage? The answer seems to be rarely — and, at last, the regulatory authorities seem to be awakening to this potential exposure in contingent liabilities.

The *Sarbanes-Oxley Act of 2002* (US) and other corporate governance codes universally call for a robust risk management regime. While in part this might account for the more aggressive

stance by buyers in setting their desired liability and indemnity terms, it offers no excuse to sellers for accepting such liabilities. Now, according to *CFO Magazine*,² the US Securities and Exchange Commission (SEC) and Federal Accounting Standards Board (FASB) have their sights firmly set on this issue of undeclared exposures. 'Most public issuers recognise no liability and disclose no loss or range of loss' when they publish their balance sheet, according to the SEC. While the FASB has no immediate plan to amend existing rules, it has declared a preference for 'companies to recognise and quantify such liabilities at an earlier stage and provide more fulsome disclosure'.

In the meantime, the credit rating agencies have started to take an interest, with analysts now taking guesses on the amount of contingent liability facing a firm. How long before the insurers jump onto this bandwagon? Overall, *CFO Magazine* rates this as one of the eight risks that will soon be on the CEO/CFO 'radar screen'. Perhaps the bandwagon for buyers — and their third-party advisers —

will soon be coming to an abrupt halt and we will see a rebalancing in the debate over liabilities and indemnities. ●



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IACCM is a global not-for-profit association for contracts and sourcing professionals. With members from more than 1000 major international corporations, IACCM undertakes extensive surveys and benchmark studies to further its aim of improving corporate performance and integrity in contracting and negotiation.

Endnotes

1. Each year since 1999, IACCM has undertaken a survey of the 'Top Ten Most Frequently Negotiated Terms'. Liabilities and indemnities consistently top the rankings.
2. 'Contingent liabilities: exposing exposures' *CFO Magazine*, April 2006.



CONTRACT LAW in practice

by Christine Lithgow CONTRACTS AUSTRALIA

Insurance clauses: it pays to pay attention

Insurance requirements are so common and have been around for so long that we often take them for granted. This is so even in the face of non-standard clauses.

If a contract asks for public liability insurance, our usual response is to provide a copy of our public liability policy. We often do this without a thought for the actual words used in the contract. But, it may be that the words in the contract require something more or different.

When this happens and we don't in fact have the insurance required by the contract, we may be in breach. In addition, our liability for breach will put us in the position of an insurer, liable to cough up for an event over which we may have no control or for which we have no responsibility.

The same operates in reverse, of course, when we are in the position of a buyer. Our risk managers, insurers and lawyers may have negotiated long and hard to get our insurance clauses just so.

But, if we don't enforce the clauses, we may end up with uninsured exposures, leaving us to recover from our usually 'less than deep pocketed' contractors.

A case study illustrates how one unlucky supplier to government found itself carrying the can for the government's negligence.

Chubb was a supplier of security services to the Commonwealth Government in the Tax Office building in Sydney. One of the Chubb security guards was asked by a Commonwealth officer to move a TV monitor in the premises. As she went to do that, the TV monitor fell off the wall and injured her. It is evident from the decision of the trial judge that moving the TV monitor was not a requirement of her employment with Chubb or connected with the performance of the contract with the Commonwealth:

Commonwealth v Chubb Security Australia Pty Ltd [2004] NSWCA 77; BC200401595.

The security guard sued the Commonwealth for the injury sustained in moving the TV monitor. The Commonwealth was liable for this injury as occupier of the premises.

The Commonwealth in turn claimed against Chubb. The Commonwealth's argument was that the contract required Chubb to insure the Commonwealth against claims by Chubb employees and that Chubb was in breach because it had not done so. The damages sought as a result of the breach were equivalent to what the Commonwealth would have been able to recover under the insurance if it had been available.

The relevant clause of the contract was headed 'Contractor's Employees'. This clause contained a requirement that the contractor take out 'a suitable insurance policy' covering itself against:

... liability, loss, damage, claim, demand, action, suit or proceeding, costs and expenses whatsoever arising at common law or under any statute or other legislative provision, including any statute or such provision relating to workmen's compensation as a result of personal injury to or the death of any person employed by the contractor in or

in connection with the performance of the service or the performance of the contract.

The clause went on to require that:

... the insurance effected by the contractor pursuant to [the above clause] shall be extended to cover all liabilities of the Commonwealth at common law and under any applicable statute or other legislative provision.

Chubb had taken out standard workers compensation insurance, but had not taken out any additional insurance to cover the Commonwealth.

about the specific circumstances concerning Chubb and the Commonwealth (and the Court of Appeal judgment is light on detail), but I think it is fair to speculate that:

- Chubb and the Commonwealth probably had an established relationship, with dealings not just limited to the ATO building (even the contract in question was almost one year old at the time the security guard was injured);
- the contract was presumably a

Effectively, Chubb was arguing that the clause should be read down, having regard to custom and practice and an industry understanding of what these types of provisions require.

Chubb argued that the contract clause required a workers compensation type of policy with a common law extension. It argued that the common law extension would provide cover to the Commonwealth only in the event that an employee of Chubb sued it, alleging that the Commonwealth was his or her employer or deemed employer as a matter of law and was liable as employer or deemed employer.

Effectively, Chubb was arguing that the clause should be read down, having regard to custom and practice and an industry understanding of what these types of provisions require. The NSW Court of Appeal had little regard for this interpretation, but simply looked to the words of the contract.

The Court of Appeal found in favour of the Commonwealth, based on the wording of the contract.

The court's decision is not remarkable in the way it interprets the clause. What is interesting are the practical implications and the context. Personally, I don't know anything

standard form which had been used elsewhere — and so there was likely to be an established custom and practice about what insurances were actually required to be provided under it;

- Chubb had probably advised the Commonwealth of the insurance cover it held — either by way of evidence of insurance post-award (usually required annually) or as a tender requirement; and
- the Commonwealth's contract manager was probably aware of the insurance held by Chubb (being in receipt of proof of insurance).

None of these factors (or anything like them) was mentioned in the Court of Appeal. All that the court was concerned about was the wording of the clause. There are lessons for us all in that. ●

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Insured or unsure? Outsourcing risk and professional services

Frank Maher

LEGAL RISK

This tale begins with Enterprise International Corporation (Enterprise), a major multinational conglomerate with extensive commercial interests in a vast number of market sectors. The names and some other details have been changed to protect identities, but the underlying facts are only too real and resulted in a multimillion pound loss for Enterprise.

Enterprise would buy up underperforming businesses and integrate them into its established businesses.

As such, Enterprise was a major spender on legal services with some of the largest law firms in the world. Recognising an opportunity to cut costs, it established its own legal department to deal with the merger and acquisition work. From time to time, however, it sought outside legal services. Such an occasion arose when Enterprise decided to buy Creditloan Ltd, a niche provider of consumer credit in the UK.

Enterprise's inhouse counsel instructed the corporate partner from Arthur Gilbert, a longstanding law firm with which Enterprise had an excellent relationship, albeit on the property side rather than corporate. The instruction letter from Enterprise read:

The first batch of due diligence material has arrived at my office and I am going to have a look at it and send you any documents I need you to review.

In the meantime, I attach a short memo that my assistant and I have put together setting out the various products that Creditloan provides. Since we have all found their products somewhat confusing, perhaps once you have considered this memo, you could phone me so we can check whether we are clear enough about it.

Arthur Gilbert was only instructed on part of the job, with Enterprise's inhouse team doing the rest.

The team at Arthur Gilbert dealt with the tasks handed out to them by Enterprise with unremitting enthusiasm, though not without difficulty as the dividing line between what they were doing and what Enterprise's inhouse team was doing was not always clear. However, Enterprise's solicitors inevitably channelled all communication through the corporate partner at Arthur Gilbert.

During the course of the due diligence, it emerged that there was some doubt about whether Creditloan's credit agreements with customers complied with relevant legislation; if not, they would be unenforceable in the courts and the book debt would be worthless unless customers paid off their loans in ignorance of the technical defect.

The assistant to Arthur Gilbert's corporate partner mentioned this in a note to Enterprises's inhouse counsel, along with a host of other matters of concern, such as employment contracts and tax warranties. An indemnity was included in the Sale and Purchase Agreement, but it had a two-year time limit for any claim.

A couple of weeks before the date set for completion, Enterprise's inhouse counsel left for pastures new. A junior lawyer with little merger and acquisition experience took over. Matters became more confused from this point on as to exactly who was doing what. Eventually, the matter reached completion and the £25 million purchase price was handed over.

After completion, Enterprise transferred Creditloan's business to another subsidiary. This time the legal work was done inhouse.

A few months down the line, there was a court challenge to one of Creditloan's agreements and it was found to be unenforceable. Although Enterprise had been told about it at the time and reminded after completion, it never gave a thought to claiming under the indemnity in the Sale and Purchase Agreement within its two-year time limit.

Enterprise was seriously concerned that its investment was all but worthless, and instructed fresh lawyers to sue Arthur Gilbert for failing to advise it that the book debt, which was the company's only significant asset, was worthless and that it should not have proceeded with the purchase.

Arthur Gilbert's insurers instructed lawyers to investigate and defend the claim. The key issue was identifying who had responsibility for investigating the validity of the credit agreements. The starting point for such an enquiry would invariably be the engagement letter. But apart from the brief memo mentioned above, there was none. Nor was there an agreement on fees — Arthur Gilbert's corporate partner did not like sending them because they seemed overly formal and clients neither wanted them nor read them.

Attention then turned to the memo from Arthur Gilbert to Enterprise's inhouse counsel drawing attention to the issue, but there the trail went cold. Enterprise's inhouse counsel who had initially handled the matter had left with no clear instruction to the junior lawyer taking over the matter or other colleagues as to what was to be done on this issue. And nobody thought to draw it to the attention of the director responsible for managing the project. Arthur Gilbert had mentioned it in a post-completion report, but it seemingly went unread, as no alarm bells sounded in Enterprise.

Ultimately, the claim settled for about £1.5 million, leaving Enterprise nursing a hefty loss on its £25 million investment.

Lessons for the contract manager

The lessons from this case are there for all to see, but from the contract

manager's perspective, there are particular points to note, many of which are of general application and not just confined to instruction of law firms.

- It is crucial to insist on a proper engagement letter when instructing outside lawyers, and even more so where an inhouse team is doing part of the work, as the risk of something 'falling between two stools' is ever present.
- The terms of engagement should be scrutinised with great care. Is the law firm seeking to limit liability, for example? Increasingly, law firms in the UK are doing so — a survey by Legal Risk of the Top 100 UK Law Firms¹ identified that only 9 per cent

Commonly, companies will ask about a law firm's level of professional indemnity insurance, but with scant regard to how much protection it may in fact afford them.

of respondents never seek to limit liability contractually, the rest do either all the time or sometimes. If they do limit liability, is the limit sufficient for your purposes? Bear in mind that your losses may not be limited to the initial investment.

- If tasks are going to be shared between an inhouse team and external advisers, there needs to be proper and detailed management of the division of responsibilities. It is easy for lines to become blurred, and the speed of many mergers and acquisitions only serves to increase the risk.
- If key players move on during the deal, proper and detailed handover is essential. Notice periods in employment contracts should be used as a period for detailed debriefing of those departing.
- If you only instruct lawyers or other professional advisers to do part of a job, although it may save on fees, it may mean you only recover part of your loss when it goes wrong — it may depend on whether the damage falls within what lawyers refer to as the 'scope of duty'.²

- Never assume that because a firm of professional advisers is insured, the money is 'in the bank' if the matter goes wrong. Allocation of blame is frequently complex, as is the legal measure of damages for which a party may be liable, and there will often be a shortfall in a claimant's expectations of compensation — perhaps because, as in the case study, the claimant must accept some or even most of the blame, perhaps because of some other legal technicality.
- Read post-completion advice from lawyers.
- Having read the post-completion advice, diarise any time limits.
- Arthur Gilbert asserted that it only owed a duty to Enterprise, and not to

the subsidiary company to which Creditloan was later transferred, so it is important to ensure that a duty is owed by the advisers to any other acquiring company.

Outsourcing is essential to many businesses and the use of outside lawyers is part of the process of managing risk, with panel appointments being a significant issue in the field of banking and insurance in particular.

If commercial institutions are to derive some comfort from panel appointments for their own risk management processes, they need to have some assurance of the degree of risk management within the firms they instruct.

Commonly, companies will ask about a law firm's level of professional indemnity insurance, but with scant regard to how much protection it may in fact afford them.

First, the level of cover which is material is that carried by the firm at the time the claim is made or, if earlier, when it notifies its insurers of circumstances which may give rise to a claim, as it may do if it realises it may have made a mistake. But that may be

many years in the future, and by then the firm may have less cover for any number of reasons.

Second, the extent to which the firm has cover will depend on whether it has complied fully with its obligations to insurers. Although some statutory insurance schemes imposed by law societies may prevent insurers repudiating claims, that will only apply to the minimum level of compulsory cover and not to any top-up insurance the firm carries. Frequently, law firms fail to carry out a full enquiry of *all* staff as to matters which must be notified to insurers, and there is some evidence of increasing numbers of indemnity disputes between law firms and their insurers.

Third, a number of law firms have found to their cost in recent times that they have been let down by insurers which have collapsed, HIH and Independent being two of the more notable examples.

It follows from this, therefore, that companies outsourcing their legal and, indeed, other professional services should have more than a passing interest in how the firm manages its risk. They are entering into a partnership with their service providers, and in many cases the way in which the firm delivers its services will be seen by the client's own customers as the focal point of a transaction; for example, whether it is funding a loan or handling an insurance claim.

They would not undertake other risk-sharing ventures without a full enquiry of their partners.

Law firms manage risk to varying degrees and standards. The investment in law firms' services is substantial and the firms' enthusiasm to be appointed in the majority of cases cannot be underestimated. Their ability to provide a seamless service should be tested, and that means a proper review of how they manage risk across the practice. It also means ensuring that the firm will be there for the long term; this is not even just a business continuity planning issue, as strategic failures can be as damaging — as the collapse of at least two large American international law firms in recent times demonstrates; in this context one might also recall the collapse of Andersen.

Risk management is a company-wide issue and those who invest in legal services should be concerned to ensure that firms address their strategy, financial management, facilities and information technology, people management, supervision and operational risk management, client care, and file and case management.

Experience of investigating claims on behalf of law firms' insurers confirms that failure in these areas can all be contributors to professional liability claims. Even what appear to be simple administrative errors may, on closer examination, be attributed to inadequate internal communication or inappropriate delegation, lack of training or failure of computer systems.

The message, therefore, is to consider how much you are investing in law firms and other professional service providers, how much your reputation depends on their service, and whether you can afford to leave that risk to chance, or whether you should instead be investigating in more detail how well they manage their risk. The losses of Enterprise could pale into insignificance when compared with your own. ●



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Legal Risk is a UK firm of practising solicitors specialising in risk management, professional indemnity and anti-money laundering compliance which advises many leading law firms, other professional firms and their insurers. Frank is the author of Risk Management for Law Firms and co-author with Sue Mawdsley of The Money Laundering Reporting Officer's Handbook: A Guide for Solicitors. The firm has an international client base as far afield as Australia.

Endnotes

1. The full survey report is available for download at www.legalrisk.co.uk, News and Events page.
2. Applying *South Australia Asset Management Corp v York Montague* [1997] AC 191.

Commitment management: a new name for an emerging profession — IACCM Americas Conference 2006

Christine Lithgow CONTRACTS AUSTRALIA

*What's in a name? That which we call a rose
By any other word would smell as sweet.*

— William Shakespeare,
Romeo and Juliet

Well, we all know that's not true — even Juliet knew this, despite her best efforts to persuade herself that Romeo's surname was of no consequence; it was that very name that made their love doomed from the start.

And so, on to scene 2. The scene opens at Paradise Point Resort in San Diego, California. The sun is shining (well, there is occasional rain), the delegates are assembling ... it's the International Association for Contract and Commercial Management (IACCM) Americas Conference 2006! And I'm there!

I was fortunate enough to be a delegate at the recent IACCM Americas Conference (27–29 April).

The strong theme of the conference was 'commitment management'.

'Commitment management' is a term coined by the IACCM to provide a name for what its members do. The new name brings together the various contracting disciplines under one umbrella. We are all of us — whether contracts lawyers, supply chain managers, logistics managers, contract managers, contract administrators, negotiators, purchasing officers, procurement managers, strategic sourcing officers or sales and business development managers or negotiators — engaged in the business of managing our organisations' or our clients' commitments.

And, of course, just as there was more to Romeo than his name, so too commitment management is more than just a name. As defined by Tim Cummins (the Executive director of IACCM), commitment management is:

... an advanced method through which contracts and sourcing professionals can

meaningfully apply quality principles to business terms, policies, practices and processes to drive improvement in negotiation, contract performance and governance standards. It offers a systematic way of ensuring that business requirements and capabilities are aligned to formal commitments, to ensure that business relationships are fulfilled as agreed.

As Tim explained in his session at the end of day one, 'Gaining the CEO's attention: how events and knowledge can transform our world', it is essential to the survival and growth of our professions that we start to identify, quantify and make known the value that we add to businesses. (I am paraphrasing here, but I believe I caught the gist). Commitment management is a philosophy and a vision for the future of the profession and is coupled with the development of IACCM and with the development of a strategic, systematised and best practice approach to what we do.

Tim lit the commitment management fuse, but he was followed up on the morning of day two by Aussie Daniel Kwok talking about 'Twinning contracting with quality — a fresh mindset to a new business dynamic'. When Tim wrapped up at the end of this session, it was clear that commitment management and quality management are seen as progressing hand in hand. The principles and philosophies of quality management (particularly zero tolerance for non-conformance and metrics for measuring the cost of non-conformance) are seen as very relevant and useful for the discipline of commitment management.

On day three, the commitment management theme was picked up again by Bill Huber and Jim Bergman in their session on 'The 10 best practices in commitment management'. This was an interactive session exploring the results of IACCM research on what members believe to be the 10 best practices in

contracting. Given the level of consensus about these practices, it is likely they will provide a framework all organisations can adopt in the management of their contractual commitments.

Some of the really rewarding sessions at the conference were about cross-cultural communications. Being in the US and among international household name suppliers really does make the world feel like a global village, and the management of cross-cultural issues is clearly front of mind for our US counterparts. We had some really entertaining, informative and rewarding sessions on these topics — including Reema Ali on dealings with the Middle East and Oscar van Weerdenburg on cross-cultural issues generally.

I also attended some fabulous case studies on the implementation of contract management systems into organisations. The case studies gave real insight into the need to manage any systems implementation from a 'whole of organisation', 'whole of function' basis, project managing each step of the way, aligning existing systems and processes with the contract management system and gently bringing recalcitrant areas of the organisation on board. One thing of particular interest to me was that the lawyers were really at the forefront, encouraging the adoption of technology in this area.

Best of all though, I met many wonderful and inspiring people and I had a great time. Any sponsors for next year's conference?

Copies of the papers from the conference are available at the IACCM website at <www.iaccm.com> in the Resources section. ●



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Effective contract management in the insurance claims industry: implications for clients

Doug Hudgeon and Peter Cubit
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When you think of your company's insurers, the face that comes most readily to mind is probably that of your broker; and when you think of contract management issues, you are likely to think about the issues involved in sourcing a suitable policy. But your company probably spends far more time dealing with your insurers' claims departments than with your broker, and those claims departments will probably allocate your work to third-party suppliers rather than one of their own employees. As a result, the most critical contract management issues are often those addressed by your insurer rather than by you.

Let's look at a scenario.

In 2005, your company insured its workers compensation with ABC Insurance. The cost of this policy did not differ significantly from that of any of ABC's competitors so you selected ABC based solely on the recommendation of your broker.

In early 2006, one of your employees suffers an injury and provides you with a medical certificate indicating that he will be off work. You file a workers compensation claim and an ABC claims officer gives you a call.

The claims officer sends your injured worker to a third-party doctor who indicates that she doubts the veracity of the injury. The claims officer then retains a factual investigator who spends a day at your workplace determining the facts of the matter. The factual investigator recommends surveillance on the injured worker. This occurs and the months pass.

Meanwhile, on several occasions, the injured worker sees the third-party doctor and two medical specialists, all appointed by ABC. The injured

worker retains a solicitor who commences litigation against your company. ABC responds by retaining a solicitor to represent your company. They appoint an expert witness to review your workplace practices. They retain a barrister to represent you in court.

A year later a representative from your company goes to court and warmly greets the solicitor, barrister and factual investigator, all of whom the representative has dealt with extensively over the previous two years. The injured worker nods in recognition at each of the doctors he has seen over the past two years and glances quizzically at the surveillance operative, trying to place him. Your company representative also, for the first time, shakes the hand of the claims officer, the only ABC employee present and the only ABC employee to whom anyone in your company has ever spoken.

Now, keep in mind this allegory is simplified and it is likely that your insurer will have escalated the claim from the initial claims officer to a more senior claims officer. It is also likely that in your state, the workers compensation Act requires a settlement conference before the trial, but the fact remains that ABC is likely to make contact with your company through third parties rather than through its employees. If ABC skilfully manages these contracts, you are likely to have better outcomes than if it does not.

Why should you be interested in the outcomes? In the above example, your injured worker may well have had a valid claim and ABC's decision not to pay it has severely inconvenienced him. While an ABC employee made

that decision, he or she based the decision on information received from third-party providers. Alternatively, your company may not be responsible for the injured worker's claim and, if based on information provided by its third-party providers, ABC paid the claim or, if due to the performance of solicitors or barristers retained by ABC, your company lost in court, your premium may increase by tens or hundreds of thousands of dollars.

So, how should ABC manage its third-party suppliers? The remainder of this article discusses best practice in third-party contract management in the insurance claims industry and concludes with some simple questions that you may want to ask your insurer about its contract management practices.

What types of services do insurers contract to third parties?

What types of services do insurers contract to third parties and how do they structure those contracts?

ABC Insurance, like many Australian insurers, contracts out nearly all work conducted outside the walls of its offices. The types of service providers it typically retains are solicitors and barristers, property assessing and investigation operatives, and medical professionals, such as doctors and rehabilitation providers.

ABC will retain most if not all of these service providers under a panel arrangement. A panel is a pre-qualified group of service providers who provide services under the terms set out in a head agreement.

A panel system allows ABC access to geographically disparate, pre-qualified service providers, at discounted rates, without the need for complex negotiation and risk assessment. Without panels, ABC as a national organisation with clients and claimants located across Australia would require an extremely large workforce. Instead, it relies on local service providers to meet with its clients and claimants and it manages these providers using panels.

Best practice panel structures and management

ABC, as a skilled panel manager, realises that the starting point for effective panel management is ensuring that each panel member receives enough work to keep him or her interested in remaining on the panel. The maximum size for any panel equals the total number of jobs available divided by the minimum number of jobs required to keep members interested. For example, if ABC annually sends 1000 work requests to solicitors and each law firm requires 100 jobs per year to view ABC as an important client, then the maximum size of the panel is 10 firms.

Once the panel is established and ABC starts allocating work to the panel members, it can then begin letting the naturally competitive structure of panels work for it. To do this, ABC will compare each panel member's performance against that of the other panel members and occasionally bring in an outside supplier to assess the competitiveness of the panel members against the larger market. Ideally, ABC will collect and analyse this data using a commercial panel management system.

Once performance data is collected, ABC provides incentives for panel members to improve their performance. Incentives can be positive, such as increasing the volume of work allocated to the high performance providers, or negative, such as removing the poorly performing providers from the panel.

Making the rubber meet the road

Once the panels are established, claims officers allocate work to the panel members, and an appropriate incentive system is put in place and communicated to the panel members. ABC must then ensure that its claims officers utilise the incentive scheme. This is not a trivial matter. ABC Insurance may have 1000 claims staff located across the state and territory capital cities. Without a method of constraining the allocation of work to the panel members, ABC would be unable to offer to the panel members

any effective incentives for good performance.

To address this situation, insurers can use commercial allocation software or they can take the decision out of the hands of the individual claims officer by using a centralised allocation department to allocate work.

Either way, the successful management of providers relies on all providers believing that ABC will reward them for good performance and punish them for poor performance. Without this belief, the entire panel management system falls to pieces and ABC Insurance provides poorer service to your company.

Questions for your insurer

This article has provided you with sufficient background to understand the panel management capabilities of your insurers. To assess how well your insurers manage their third-party suppliers, ask them the following questions:

- What types of providers do they manage using a panel system?
- For each of these panels, how much work does the average panel member receive annually?
- What key performance indicators (KPIs) have they set for each panel?
- How do they measure the KPIs?
- What incentives are in place to reward providers who excel at meeting their KPIs or penalise those providers who fail to meet their KPIs?
- How do they ensure that the incentives are utilised by claims staff and that the panel members believe that the incentives are meaningful? ●



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Insurance risk — protecting managers and directors

Fiona Shand

SHAND AND ASSOCIATES

As a result of such spectacular collapses as the US\$63 billion collapse of Enron, the US\$104 billion demise of Worldcom and, closer to home, HIH, One.Tel, Harris Scarfe and the challenges faced more recently by James Hardie and AWB, corporate regulators and the courts are applying ever stricter interpretations of corporate governance within the existing regulatory and common law framework. The tension between shareholders' expectations of directors and managers and the ability of those directors and managers to meet those expectations will necessarily increase rather than decrease in the present corporate climate.

Most commentators and governments claim that corporate failures are proof that the existing framework of directors', officers' and managers' duties and obligations is inadequate and should be toughened. The Corporations and Markets Advisory Committee (CAMAC) has recently released two papers. *Personal Liability for Corporate Fault* reviewed when (not if) directors and managers should incur personal (including criminal) liability for corporate misconduct arising from their positions or functions rather than their own misconduct. In *Corporate Duties Below Board Level*, managerial duties and liabilities under the *Corporations Act 2001* (Cth) were highlighted. In this climate, the burden of responsibility on risk managers to devise adequate protections for their corporate colleagues has increased. (Copies of both papers can be obtained from the CAMAC website at www.camac.gov.au).

Acting upon the tougher expectation, a 'cashed-up' Australian Securities and

Investments Commission (ASIC) is adopting a more public and vigorous approach, evidenced by the personal pursuit of Jodie Rich, Rodney Adler, Ray Williams, John Elliott and Steve Vizard. However, below the public surface of these director prosecutions, there have been strenuous investigations into the less public face of the company. Lower or middle level managers associated with these corporate irregularities have found themselves scrutinised by ASIC investigators. This scrutiny, in line with the CAMAC recommendations, is set to become a permanent feature on the corporate landscape and will inevitably lead to managerial prosecutions.

The defence of 'following orders', once viewed as an answer to charges, has evaporated as ASIC, the courts and the community hold expectations that all individuals will engage in a vigorous process of self-examination and assessment of the corporate matrix into which their actions fit. This expectation has been borne out by the embedding of whistleblower protections. Obviously, the corporation's primary risk and oversight processes and procedures are the major tools to identify and eradicate possible breaches. These programs, developed and maintained by the company, its officers and managers, will ultimately provide protection from prosecution, but what will give comfort to the directors and managers in the often lengthy period between default and exoneration? This interval may be weeks, months or years, during which time directors and managers will need advice, often separate from the company. The greatest comfort in this scenario will be provided by specific insurance tailored to respond during

the investigation and prosecution phases. Lest risk managers forget, their own roles and actions may be under scrutiny in this scenario, so an element of self-interest is not inappropriate. Specific insurances, such as directors and officers and legal expense policies, may be the answer to this dilemma.

In the past, it has been extremely rare for directors to receive, let alone review, the actual wording of their directors and officers cover, except in circumstances where a claim has been notified or lodged against them. Normally it is the company's secretary (and/or perhaps CEO) who would obtain the cover with the assistance of the company's insurance broker, including reviewing the wordings and cost and deciding on the underwriter. It has been my experience that when a director has requested access to the policy, there has been some reluctance to provide the documents, usually citing confidentiality. While directors and officers policies do usually contain confidentiality clauses to preclude disclosure of the existence and terms of the cover to third parties including claimants (or potential claimants), this reason should not preclude a director, or indeed an officer, as an insured under the policy, from sighting the wording.

Assessment of the wording of any directors and officers policy can be difficult due to the complicated nature of the wordings. If any query arises as to the nature and effect of any particular clause, assistance can and should be sought from the company's insurance broker. Some key features to identify, questions to ask or coverage to include in the wordings are:

- the underwriter (for solvency purposes);
- the policy limit, including whether it is aggregated;
- any excess applicable to claims;
- coverage available to other parties within the wording, including the company itself, which may reduce the amount of cover available to other parties;
- any exclusions, including territorial exclusions — for example, the US and Canada;

- restrictions on retaining your preferred legal advisers;
- whether the policy is claims made and/or circumstances notified;
- the policy period and any run-off arrangements for exiting insureds, including directors and officers;
- insured versus insured coverage; and

Lest risk managers forget, their own roles and actions may be under scrutiny in this scenario, so an element of self-interest is not inappropriate.

- advance payment of defence costs and what restrictions may apply to them.

This is not by any means an exhaustive list, but it serves to highlight some of the areas relevant to directors and officers insurance. The last item deserves some emphasis, given that not all directors and officers policies contain this feature. Insurers are entitled to withhold decisions on indemnity until they have sufficient information to assess the claim. That information-gathering exercise may take a considerable time, while in the interim the claim is being pursued and legal costs incurred. An 'advance payment of defence costs' clause provides that the insurer may pay the directors' or managers' legal costs before a decision on indemnity is made. In the event that the costs are paid and ultimately the policy does not respond, these costs must be repaid. This clause is common within most directors and officers policies and is an invaluable asset. The High Court has handed down two decisions in relation to 'advancement of defence costs' clauses in directors and officers policies (*Rich v CGU Insurance Ltd* (2005) 214 ALR 370 and *Wilkie v Gordian RunOff Ltd* (2005) 214 ALR 410). Both cases were decided on the actual working of the policy and indicate that advance payment of defence costs prior to a finding against an insured can be made dependent

upon the specific wording. It must be remembered that directors and officers and legal expense policies will never respond in circumstances of bad faith or dishonest behaviour.

Risk managers can supplement their internal risk minimisation systems with a myriad of insurance policy options — the problem is identifying the benefits

of the policies as they apply to the unique corporate environment in which they operate. The challenge of securing the best fit is not insurmountable, and ultimately the existence of these policies provides risk managers with another tool to protect their business from risk by protecting the persons conducting the business. It might even protect them. ●



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For over 20 years, Fiona has represented directors and professionals in private practice and industry in Australia, Switzerland and Hong Kong.

In 1999, Fiona represented six non-executive directors of the GIO in the \$760 million AMP takeover shareholder class action. Eventually, judgment was entered in favour of the GIO non-executive directors.

Fiona also represented clients before the recent Building Royal Commission and the HIH Royal Commission, including Grocon and Ray Williams.

In 2001, Fiona established the Sydney office of Arnold Bloch Leibler. She has recently opened her own firm, Shand & Associates, specialising in early resolution of corporate and directorial entanglements.

Using insurance as a financial tool

Ross Castle AON

Risk management is becoming widely regarded around Australia's corporate boardrooms as a key issue for senior management. Ross Castle explains how Aon's Risk Management and Total Cost of Insurable Risk Survey offers insights into how Australian organisations identify, measure and deal with their risk.

Risk management was once regarded as a routine functional task, the bastion of the risk manager alone, with little or no connection to the organisation's broader directions or priorities. These days, however, risk management functions are considerably more demanding, with CEOs and CFOs increasingly under the risk management spotlight. Boards are also playing a greater role and have increasingly assumed more responsibility for risk management strategy.

One reason for this trend is that good risk management is beginning to be seen as a key part of a broader financial management strategy and linked to corporate priorities.

Despite this, there is still a gap to be bridged in the Australian corporate community — the gap between

understanding what it means to buy insurance and what it means to look at insurance and risk within this broader financial management context.

Simply put, the key to risk management is understanding your organisation's own risk needs and using insurance as a financial tool. This inevitably leads to the concept of 'total cost of insurable risk'; that is, the costs incurred by a business (beyond the obvious premium costs) to deliver an effective risk management strategy.

Throughout the 1990s, the cheapest insurance premium was considered the best insurance deal. While this seems logical, it perpetuates an attitude that insurable risk is not something that businesses need to take seriously or manage, but instead transfer at a price.

That's why the starting point for smart insurance buying is accepting the total cost of insurable risk as the best driver of how to use insurance, rather than simply considering the cost of the premium.

CFOs and risk managers should be working together to target the lowest sustainable cost of insurable risk. This means understanding how the different components both interact and



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contribute to the total. It also means identifying the best point between retaining risk and insuring it.

The total cost of insurable risk may sound complex; indeed, risk, capital and financial management are not simple subjects. How can insurance be a solution to risk and financial management needs if you don't know:

- whether the solution matches your insurable risk needs;
- the right amount of insurance to buy; or
- the point at which it is cheaper to retain risk rather than to insure it?

Without a deep appreciation of your risk needs and how to use insurance, you are simply left buying a 'product' that the markets are prepared to sell, as opposed to selling the insurable risk that you do not want to retain.

To help bridge this gap in understanding, Aon Australia has developed the Risk Management and Total Cost of Insurable Risk Survey. The survey gives organisations an insight into the emerging risk financing and risk management trends across corporate Australia. It also enables those responsible for risk management to benchmark their strategies and costs with their industry peers across the country.

As always, the results highlight some interesting trends and insights.

- Corporate governance is the key risk concern this year — no doubt reflecting the sizeable regulatory burden currently facing Australian organisations and the heightened focus on directors and executives. However, there appears to be a swing back to growth-related risk concerns, with 'lack of innovation' emerging as a key risk.
- The importance of technology and information management, particularly as a source for reliable risk management information, has also emerged as an increased risk concern for many organisations.
- The ability to attract and retain key staff is a continuous concern for Australian executives. This factor, combined with an ageing workforce and with the emergence of stress as an occupational health and safety

2005/06 top 10 risks concerns

| Rank | 2002/03 | 2003/04 | 2004/05 | 2005/06 | Change from 2004/05 |
|------|-----------------------|-------------------------|------------------------|------------------------|---------------------|
| 1 | Legal | Brand and image | Brand and image | Corporate governance | ▲ 1 |
| 2 | Brand and image | Physical assets/Systems | Corporate governance | Systems | ▲ 3 |
| 3 | External dependency | — | Regulatory | Brand and image | ▼ 2 |
| 4 | Market structure | Human resource | Legal | Human resource | ▲ 2 |
| 5 | Human resource | Legal | Systems | Legal | ▼ 1 |
| 6 | Systems | Corporate governance | Human resource | Liquidity | ▲ 1 |
| 7 | Regulatory | Market structure | Liquidity | Information management | ▲ 3 |
| 8 | Shareholder needs | External dependency | Physical assets | Business interruption | ▲ 5 |
| 9 | Corporate governance | Liability | Capital structure | Capital structure | — |
| 10 | Intellectual property | Liquidity | Information management | Lack of innovation | New |

issue, will mean that workforce issues are likely to feature more prominently as key risk concerns over the next few years.

- The ongoing trend towards offshoring and outsourcing, and the reliance businesses have on external suppliers to run their own business is also an emerging risk issue. Many companies have followed the trend towards concentrating on their core business — outsourcing and offshoring for cost and efficiency reasons. But have they considered all their risks and dependencies and are the implications of business interruption factored into these business decisions?
- We are also witnessing a recurring theme — that of risk culture. Whether risk management responsibilities are centralised or decentralised, organisations have identified the need to reinforce risk frameworks and systems through the right risk culture and behaviors.
- Other 2005/06 survey findings include:
 - 88 per cent of organisations have established either full or partial risk oversight and management policies;

- the median total cost of insurable risk was \$8.69 per \$1000 of revenue, a decrease of 8.5 per cent from last year;
- all industry sectors have progressively increased the amount of the overall risk dollar they spend on risk management, climbing from 14 per cent in 2002/03 to 20 per cent this year;
- more organisations (55 per cent) are getting actively involved in 'selling' their risks into the insurance market, up from 49 per cent last year; and
- for the fourth year running, QBE was listed as the 'most respected insurer'. ●



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Now in its fourth year, Aon Australia's 2005/06 Risk Management and Total Cost of Insurable Risk Survey remains the first of its kind in Australia. It is unique in its comprehensive benchmarking of total cost of insurable risk.

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