Allocating risk in IT contracts

The past fifteen years have seen several cases in the IT sector in which the UK courts have had to consider
the enforceability of contract limitations and exclusions under the Unfair Contract Terms Act (UCTA) 1977. The courts’ approach in these cases (starting with the landmark decision in *St Albans City and District Council v ICL* [1996]) can broadly be characterised as increasingly pro-customer and interventionist. This interventionist method appears to have reached a high watermark with the court’s decision in *Pegler Ltd v Wang (UK) Ltd* [2000]. Subsequent cases suggest a marked change in the courts’ attitude to enforcing limitations and exclusions, showing a much greater reluctance to intervene in agreements reached between experienced commercial organisations.

This article looks at case developments and the lessons that suppliers and customers can learn from them.

**BACKGROUND TO UCTA 1977 FRAMEWORK**

Under UCTA 1977, contractual terms that exclude or restrict liability for loss or damage caused by negligence are enforceable only to the extent that they satisfy UCTA 1977 ‘requirement of reasonableness’ (s2(2)). Additionally, in business-to-business contracts where the supplier is dealing on its ‘standard terms of business’, contractual terms that seek to allow the supplier to:

1. limit or exclude liability for contract breach;
2. render a contractual performance substantially different to what was reasonably expected of them; or
3. render no performance at all,

are also only enforceable to the extent that they satisfy UCTA 1977 ‘requirement of reasonableness’.

**MEANING OF ‘STANDARD TERMS OF BUSINESS’**

UCTA 1977 gives no guidance as to what constitutes a party’s standard terms of business. However, English courts have shown that they will give this term a wide meaning.

For example, case law has established that not all of the terms need to be fixed by them to be regarded as dealing on standard terms. Even where some clauses have been heavily negotiated, the parties can be treated, for the purposes of UCTA 1977, as dealing on the supplier’s standard terms if the limitations and exclusions in the contract have been left untouched. Where changes have been made to the limitations and exclusions, UCTA 1977 may still apply if those changes are not material. In *Pegler*, for example, the parties were held to be dealing on the supplier’s standard terms, despite the fact that:

1. the customer had managed to incorporate into the contract many of its own standard terms;
2. the parties had agreed that those terms would take precedence over the other terms of the contract; and
3. the supplier had agreed (minor) changes to the limitations and exclusions.

These judgments indicate that the UK courts are likely to find that a supplier is, for the purposes of s3 of UCTA 1977, dealing on its standard terms of business unless there have been material changes to the limitations and exclusions in the contract.

**UCTA 1977 ‘REASONABleness TEST’**

A contract term that is subject to the requirement of reasonableness must be:
‘A fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made.’ (Section 11(1)).

UCTA 1977 sets out a non-exhaustive list of guidelines to be taken into account in assessing whether or not a term satisfies the requirement of reasonableness. In summary, these are:

- the relative strength of the parties’ bargaining positions;
- whether the customer received an inducement to agree to the term in question, or whether the customer had an opportunity of entering into a contract with other persons without having to accept a similar term;
- whether the customer knew (or ought to have known) of the existence of the term;
- where the term excludes or restricts liability if some condition is not met, whether it was reasonable at the time of the contract to expect that compliance with that condition would be practicable; and
- whether the goods were manufactured, processed or adapted to the special order of the customer.

While the UK courts have, in most cases, placed some emphasis on UCTA 1977 guidelines when assessing the reasonableness of the relevant limitations and exclusions, it is apparent from case law that the extent to which they will take these guidelines into account varies. The courts have shown that they will take into account other factors when making an assessment of reasonableness.

**SOUTH WEST WATER V INTERNATIONAL COMPUTERS LTD (ICL) [1997]**

South West Water involved a contract for the supplying of a customer information and billing system. ICL’s solution was based on a third-party product and its ability to deliver was dependent on it entering into a back-to-back contract with that third party. Although ICL had not been able to agree a back-to-back contract, it nevertheless assured South West Water that it would and, on the basis of that assurance, South West Water awarded the contract to ICL. The project ultimately failed and South West Water brought a claim against ICL for breach of contract and misrepresentation.

ICL sought to rely on the limitations and exclusions in the contract. These included:

1. a term limiting ICL’s liability for delivering a system that failed acceptance testing to the price paid under the contract (roughly £2.2m); and
2. a term limiting ICL’s liability for breach of contract to £250,000.

The court held that the limitations were unreasonable under UCTA 1977. In addition to the fact that the £250,000 cap bore no relation to the total contract value, the court also took into account:

1. The ‘manifest unreasonableness’ of the contract terms, which meant that under the contract South West Water was in a worse situation when ICL failed to deliver anything (since ICL’s liability in those circumstances was limited to £250,000) than it would have been had ICL delivered a system that failed
acceptance testing (where ICL’s liability was limited to the contract value).

2. The ‘reckless’ pre-contract misrepresentation that ICL had made about entering into a back-to-back contract. The court rejected ICL’s argument that this pre-contract representation was excluded by the entire agreement clause. The court followed the decision in *Thomas Witter Ltd v TBP Industries Ltd* [1996], to find the entire agreement clause unenforceable on the grounds that, because it failed to distinguish between innocent, negligent and fraudulent misrepresentation, it impliedly sought to exclude liability for fraudulent misrepresentation and was, therefore, unenforceable.

**PEGLER V WANG**

*Pegler* involved a claim for the failed supply of an integrated computer system and related services. The supplier did not deny that it was in breach, but instead sought to rely on several exclusions and limitations in the contract. These included a clause excluding liability for:

> ‘Any indirect, special or consequential loss, howsoever arising (including but not limited to loss of anticipated profits or of data).’

The court held that Wang could not rely on this exclusion in these circumstances because loss of anticipated profits had been included as an example of indirect and consequential loss, the clause did not exclude liability for direct loss of profits. It is now well established that lost profit can be, and in many cases is, a form of direct loss under English law.1

The court also considered that the limitations and exclusions in the contract were unreasonable under UCTA 1977. One of the key factors in the court reaching this conclusion was the degree of over-sell by the supplier, as Wang had informed Pegler that its solution was a perfect fit for Pegler’s requirements, despite Wang’s internal analysis showing that several modifications to its solution would be required. The court drew a distinction between attempts to limit or exclude liability for breaches that were not ‘readily foreseeable’ on the one hand, and attempts to do so in circumstances where the degree of over-sell by a supplier meant that contractual breaches were ‘not unlikely’. The exclusions and limitations in a contract were much less likely to be reasonable in these latter circumstances.

**A CHANGE IN DIRECTION?**

The decisions in these cases were seen as a clear indication of the UK courts’ willingness to intervene in contracts where the courts considered that the supplier had acted ‘unfairly’. This led many suppliers to question whether it would ever be possible, in practice, to limit their potential liability in failed IT projects. It also led to a change in approach by customers in negotiating IT contracts. Rather than attempt to negotiate acceptable terms, many customers accepted whatever terms were put forward on the basis that, as they were standard terms, the exclusions and limitations would be held to be unenforceable by the courts if they were challenged.

There have now been several IT cases in which the limitations and exclusions in a supplier’s standard terms have been held to be UCTA 1977 reasonable. The judgments in these cases suggest that the courts are currently much less prepared to intervene in commercial contracts and that the customer practice of accepting whatever limitations and exclusions that are put forward by suppliers on the grounds that they can later be challenged is a dangerous one.
This less interventionist approach was seen in *Watford Electronics Ltd v Sanderson CFL Ltd* [2001]. *Watford* involved a claim for a failed supply of a mail order processing system. The supplier, Sanderson, sought to rely on a contract term that:

1. excluded its liability for indirect loss; and
2. limited its liability in any event to the price paid under the contract.

The Court of Appeal held the exclusion and limitation to be reasonable, taking into account the relative bargaining power of the parties. On this, the court stated:

‘Where substantial companies of equal bargaining power negotiate an agreement [they should] be taken to be the best judge of the commercial fairness of the agreement which they have made; including the fairness of each of the terms in that agreement... Unless satisfied that one party has, in effect, taken unfair advantage of the other – or that term is so unreasonable that it cannot properly have been understood or considered – the court should not interfere.’

**RECENT COURT DECISIONS**

As the following cases highlight, there has been no clear indication whether the court decisions have continued to be either non-interventionist or interventionist, and instead the cases have turned on the individual facts.

*GB Gas Holdings Ltd v Accenture (UK) Ltd & ors* [2009]

*GB Gas* involved the implementation of an automated billing system. Following implementation the customer, Centrica, began to experience substantial problems with the system, which led to customer accounts going unbilled and a decreasing level of customer satisfaction. Centrica brought a claim against the supplier, Accenture, alleging that errors in the billing system amounted to fundamental breaches of warranty.

The contract contained an exclusion clause that sought to exclude all types of indirect losses from recovery. The court followed *Hadley & anor v Baxendale & ors* [1854] in relation to the categorisation of losses, where direct loss is loss that arises ‘naturally, ie according to the usual course of things’ from the breach and indirect loss is other loss that:

‘May reasonably have been supposed to be in the contemplation of both parties, at the time they made the contract, as the probable consequence of the breach of it.’

The court applied this categorisation to the heads of loss being claimed, which included:
- Gas distribution charges: due to the faults in the billing system, gas distributors over-charged Centrica based on an overestimation of consumption.

- Compensation paid to customers: Centrica paid compensation to customers due to the billing problems and poor customer service.

- Additional borrowing charges: Centrica incurred additional borrowing charges due to the reduction in revenue it experienced because of the non-billing or late billing of customers.

- Cost of chasing debt not due: due to errors in the billing system Centrica incurred losses chasing debt from customers that, in fact, was not due.

- Additional stationery costs: Centrica incurred stationery and correspondence costs necessitated by having to write to customers to update them on the problems being experienced.

For all of these heads of losses, the court held that these were direct losses under *Hadley*, and accordingly were not covered by the exclusion clause and so were recoverable by Centrica.

This decision demonstrates the courts’ reluctance to allow exclusions for general categories of loss, in particular, indirect and consequential loss. It would be sensible for suppliers to consider specific types of losses it wishes to exclude under an agreement and refer to these explicitly in the limit on liability provisions.

**BSkyB Ltd & anor v HP Enterprise Services UK Ltd & anor (Rev 1) [2010]**

In *BSkyB*, BSkyB brought a claim against Electronic Data Systems (EDS) alleging that during the tender stage, EDS had misrepresented its ability to deliver an IT project. BSkyB said that, were it not for those misrepresentations, it would not have awarded the contract to EDS. BSkyB set its damages claim at around £700m. While the contract capped EDS’s liability at a much lower level, BSkyB alleged that the misrepresentations made by EDS were deceitful and, as a result, the contractual liability cap did not apply.

EDS argued that the statement in the entire agreement clause, which stated the contract ‘supersede[s] any previous discussions, correspondence, representations or agreement between the parties’, meant that any pre-contractual representations it had made to BSkyB had been withdrawn. Accordingly, EDS maintained the entire agreement clause excluded EDS’s liability for non-fraudulent misrepresentation in respect of any pre-contractual representations.

The court disagreed and held that to exclude liability in misrepresentation for pre-contractual representations, clear words are needed.2 As the wording used in the entire agreement clause merely superseded ‘representations’, this was not clear enough to achieve this. Accordingly the provision was ineffective to exclude EDS’ liability for negligent misrepresentation.

Suppliers should review their entire agreement clauses in light of *BSkyB* to make sure they are effective to exclude liability for non-fraudulent misrepresentation, either by means of an express exclusion of non-contractual remedies or a non-reliance statement.

**SUMMARY AND CONCLUSIONS**

It is apparent from these recent cases that the question of whether the limitations and exclusions in contracts will be enforceable under UCTA 1977 will depend to a large extent on the individual circumstances
relating to the contract in question and that what is enforceable in one set of circumstances may not be in others.

That said, there are some useful lessons for suppliers and customers:

- The judgment in *Watford* means that the customer tactic of accepting whatever limitations and exclusions are put forward by a supplier, without any attempt to negotiate changes, is now a dangerous one, particularly for commercially experienced customers.

- The judgment in *GB Gas* is a reminder of the distinction between direct and indirect loss under English law, and the relative breadth of the direct loss category.

- Likewise, suppliers will want to ensure that any entire agreement clauses in their standard form agreements are drafted clearly where they seek to exclude liability in misrepresentation for pre-contractual representations. Suppliers should also ensure that their entire agreement clauses do not expressly or impliedly exclude liability for fraudulent misrepresentations, to avoid the risk of those provisions failing on a legal technicality.

- Deliberate supplier over-sell is likely to be an important factor in the court’s approach to the enforceability of limitations and exclusions. Where a supplier’s sales staff have been guilty of a deliberate over-sell and the customer has relied on that over-sell in selecting the supplier, there is a likelihood that the courts will look for a way in which to deprive the supplier of the benefit of contractual limitations and exclusions where it believes it would be unreasonable for the supplier to rely on these.

- Finally, BSkyB’s success may encourage more customers to allege deceit and/or fraud against service providers. Service providers may therefore need to work harder when tendering for contracts to ensure they can justify and provide supporting evidence for sales claims.

### Notes

1. See *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] EWCA Civ 74.

2. See *Thomas Witter Ltd v TBP Industries Ltd* [1996] 2 All.