ALLIANCE CONTRACTING - THE LEGAL FRAMEWORK

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INTRODUCTION

Alliance Contracting is here to stay.

Anecdotally at least, Australian governments and instrumentalities have embraced alliancing as a legitimate means of project delivery more enthusiastically than anywhere else in the world. The private sector has been more cautious but success stories provide mounting evidence that, for the right project, alliancing is most likely to provide the best project outcome.

It is, however, particularly important that prospective participants in an alliance fully understand the radically different legal framework that alliancing entails, and consequences of adopting that framework.

This paper explores some of the key features of the alliance contracting framework.

A DEFINITION

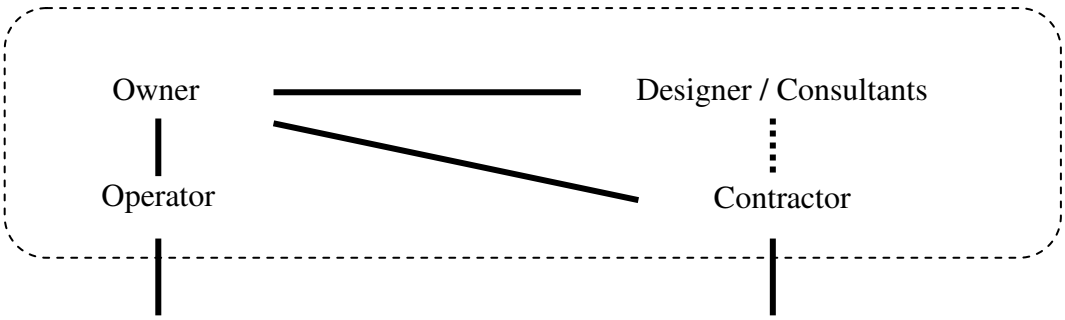
There is no succinct way to define an alliance meaningfully. One of the better definitions is that a project alliance is an agreement between two or more entities which undertake to work cooperatively on the basis of a sharing of project risk and reward for the purpose of achieving agreed outcomes based on principles of good faith and trust and an open book approach towards costs[1].

Some of the characteristics of an alliance are:

- it is non adversarial
- it has a 'best for project' focus
- the parties have a 'no blame' culture
- the objective is 'win/win' or 'lose/lose'
- the parties act collaboratively
- the remuneration for all parties is incentive-driven to maximise project outcomes

The parties intend the legal framework of the alliance to facilitate and promote those characteristics.

In order to achieve this, the contractual arrangements should deal as collectively as possible with the participants.



[1] Butterworths, Building and Construction

Users / customers / public Subcontractors / Suppliers

The owner, designer and contractor (and possibly the operator) join together to form the alliance 'team'.

OTHER SIMILAR STRUCTURES

It is useful to compare and contrast alliancing with other similar project structures.

Partnering

One of the recurring criticisms of partnering is that the terms (and risk allocation) of the contract were likely to be fundamentally inconsistently partnering objectives.

Partnering and alliancing both involve the participants 'forming a team' to achieve common objectives. However, until very recently[2], a key difference between the two is that the 'partnering' commitments reside outside the contract framework. Compare that with an alliance where the agreement itself enshrines the participants mutually agreed objectives of cooperation, 'no dispute' and win/win.

Relationship contracting

The relatively recent focus on relationship contracting has attempted to ingratiate partnering principles into, otherwise relatively conventional, construction contracts. This is typically done by inserting one or more clauses into the contract which specifically acknowledge the intention of both parties to work together, avoid disputes and maximise project outcomes.

Unfortunately, those contracts have, by and large, maintained rigid time bars, uncontrollable risk allocation and unilateral discretions, all of which work against a truly collaborative, cooperative project delivery mechanism.

An alliance contract will generally disavow those features by allocating most or all risks to the parties jointly and requiring unanimity of the parties in all or most of the decision making processes.

Joint Ventures

Alliancing and joint ventures share many common features. For both, the key objective is a mutual commercial gain and the formation of a team to carry out the project. However, joint ventures will usually result in a shared ownership of the products of the joint venture. Under an alliance, ownership will ultimately vest in one party.

Another significant difference is the way in which each parties bottom line return is calculated. Much more science (and complexity is generally applied to the calculation of the return to the alliance participants. Under a joint venture, each venturer takes a share of the ultimate profit or loss.

Partnership

Most alliances will specifically state that no partnership is created between the participants. However, expressly disavowing partnership may not be sufficient if, objectively considered, the

[2] See the English Partnering Contract, PPC 2000

arrangement between the participants is a partnership. That prospect is a distinct reality and needs careful consideration in the drafting of project documentation, to avoid the unintended application of partnership legislation.

The key elements to the statutory definition of a partnership are that the parties are:

- carrying on business
- in common
- with a view to profit

It is not difficult to see how each of these elements of the definition will be satisfied by an alliance. The project is certainly being carried out 'in common'. It is possible that all of the participants will be regarded as entering into the alliance 'with a view to profit' although, at least in the case of the owner, the alliance itself will produce no profit.

It is possible, although by no means certain, that the association of the participants of the delivery of one project only is not 'carrying on business'.[3]

If an alliance is held to be a partnership, several significant consequences may follow in relation to taxation, joint liability and accounting requirements. For example, each of the participants will owe each other fiduciary duties.

Public sector participants will need to be especially careful to avoid categorisation of partnership. There is likely to be a real issue as to whether a government agency or government department has the power to enter into a partnership in the absence of specific enabling legislation.

THE CONTRACTUAL FRAMEWORK

One agreement or two?

The delivery of an alliancing project is usually set out in a project alliance agreement, alliance contract or similar.

However, it is frequently the case that, during the feasibility and budget preparation stage, and before the project budget is finalised and the participants' margins and pain/gain arrangements have been resolved, an interim agreement is put in place.

The interim agreement is generally similar to a consultancy agreement pursuant to which the owner engages the services of the other parties to collaboratively prepare the project budget, conceptual design and project execution documentation. If no agreement can be reached on the budget, the agreement terminates and the project does not proceed.

The rationale for having two agreements is that the relationship between the parties during the feasibility phase and execution phase is different. During the feasibility phase, the interests of the participants are not fully aligned, and cannot realistically be aligned, where they are negotiating the pain/gain outcomes of the project. It is only when that process is complete, and all aspects of the financial arrangements between them have been resolved, the parties can truly commit to alliance principles.

[3] See for example *United Dominion Corporation Limited v Brian Pty Ltd* (1985) 157 CLR 1 where a partnership was found to exist between parties to a land development joint venture

The contrary argument is that, during the feasibility stage, it is important to reinforce alliance principles and a separate agreement serves only to magnify the distinction between the participant's behaviours in each phase. There is the prospect that the alliance will not get off to the right start.

However, in addition to the philosophical distinction, there are a number of practical issues which make it difficult to deal with the feasibility stage in the same agreement as the execution stage. If the agreement is to be negotiated prior to the commencement of feasibility phase, the liability and insurance arrangements will pose significant problems. It is extremely unlikely that the insurance program for the entire alliance will be known at this stage and, in the absence of that program, the respective insurance requirements of the participants will inevitably be uncertain. The interrelated issue of, 'outturn' liabilities is discussed below.

The interface between the two agreements needs to be clearly spelt out in two important ways:

First, if the project agreement does not proceed, the rights of all parties should be clearly identified in relation to:

(a) how the interim agreement can be terminated;

(b) the right of remuneration of the non-owner participants - particularly whether, and in what circumstances, they become entitled to be paid a profit component on work done;

(c) intellectual property rights in the conceptual design carried out.

Second, if the project agreement does proceed, it should be clear that the services provided under the interim agreement (and in particular the design which has been carried out) are 'rolled into' the project agreement. That way, there can be no uncertainty as to the liability and risk of the participants for negligent design in the interim phase.

The collective approach

One of the real strengths of alliancing is that it creates a 'one team' structure for the project and alienates that team from the wider organisations of the participants. This is done at two levels - the project team and the alliance board.

At the board level, it is usual (but not invariable) for the representation of the parties to be equal. More importantly, decisions on all matters, with very few exceptions, must be unanimous. The parties are forced to find common ground.

One significant bi-product of this collective approach is that the Owner surrenders 'control' of a number of aspects of the project to the Board. For example, the usual rights given to owners (or their contract administrators) with respect to directing variations, identifying defects, approving design, and determining completion are given to the Board.

Good faith and fiduciary obligations

All participants agree to adhere to alliancing principles to maximise project outcomes. They also agree to act in good faith to each other. That commitment creates the potential for some undesirable consequences.

The boundaries of 'good faith' obligations are, legally at least, very blurred. It is not a term that lends itself easily to definition. Generally it means fairness, honesty and reasonableness[4], but those are very subjective characteristics and accordingly mean different things to different people.

Good faith generally stops short of creating a fiduciary relationship which would require the parties to act, in some cases, to their own detriment in order to protect the interests of other parties.

However, in the context of alliancing principles, and the express commitment to 'best for project', it is not difficult to see the genesis of an obligation to other participants which approaches a fiduciary status. It is true that large corporate players are generally regarded as 'big and ugly enough' to look after their own interests and the courts are generally slow to impose fiduciary obligations where there is an equality of bargaining power. However, particular in the case of the owner, there is a high level of reliance (perhaps even dependence) on the behaviour of the other parties. It is not entirely fanciful to imagine a court construing the alliance as giving rise to fiduciary duties.

Whether or not a fiduciary duty exists will always depend on the particular circumstances of the relationship, however, the courts have recently been willing to impose a duty in the context of a joint venture[5].

The similarity of the joint venture relationship with alliancing is obvious from this passage of the judgment:

> '*I have no doubt that each party had to perform its obligations within its domain for the common good of the venture and each party relied on the other party to carry out the obligations bona fide and for the common good. In my opinion each party reposed confidence and trust in the other and this was appreciated at the outset.*'[6]

That does not mean that the parties should reject good faith obligations. They should, however, carefully consider the potential consequences and be sure those consequences are palatable.

Treatment of risk.

Risk allocation in construction contracts has been a contentious issue within the Australian construction industry for well over two decades.

Increasingly through the 1980s, the approach taken by owners and developers was to transfer as much risk as possible to the contractor on the understanding that those risks would be priced, but in the hope that at least one tenderer was prepared not to fully price them. The outcome was often a contractor with significant losses who engaged his lawyers and claims consultants to develop creative ambit claims. Claims for disruption, misleading and deceptive conduct and negligent misstatement were rife.

In the collective treatise 'No Dispute'[7] published in 1990, the industry was urged to return to the Abrahamson Principle that risk ought to be allocated to the party best able to manage it.

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[4] See *Coal Cliff Collieries v Sijehama* (1991, Unreported) per Kirby J

[5] See, for example, *Aqua Mex Pty Ltd v MT Associates Pty Ltd*, an unreported Victorian Supreme Court decision in 1998.

[6] per Gillard J

[7] 'No Dispute' - Strategies for improvement in the Australian Building Industry - A report by NPWC/NBCC joint working party, May 1990.

Although the response to No Dispute has been patchy, the 1990s did see a movement away from contracts which completely transfer risk to the contractor.

However, conventional project delivery still requires allocation of risk to particular parties. For example, the risk of latent conditions, scope changes, legislation changes, time overrun, delays by authorities and industrial action are all usually allocated to either the owner or the contractor.

In contrast, it is fundamental to the principles of alliancing that little or no risk be separately allocated to particular participants. If there is to be complete collaboration, it must be underpinned by joint acceptance of the risks of the project.

So, in an alliance contract, we do not see a latent conditions clause, or liquidated damages for late completion or even clearly defined rights to payments for variations. Project risks of money, time and quality are jointly assumed by all participants.

There is one important caveat to that proposition. Because the non owner participants are generally entitled to full recovery of the costs incurred during the alliance, there is effectively a 'cap' on the aggregate on the risk sharing undertaken by them. That cap is the amount of profit and overhead recovery which each participant puts at risk. There is no question that those amounts may be significant in the context of large projects, however, once the project overrun exceeds the aggregate of those amounts, the owner has a sole (uncapped) exposure for that overrun.

Two-way street

Generally, the non-allocation of risk is seen as benefiting the non-owner participants. That is because many of the risks traditionally allocated to contractors and consultants (eg. time, design, defect rectification) are shared by the owner.

However, it is important for non-owner participants to acknowledge that there are also some risks usually borne by the owner which are shared in an alliance. For example, legislative risk, environmental and cultural heritage risk and sometimes occupation risk is shared.

Equally important for the non-owners is the assumption of each others usual risks. the contractor shares the design risk and the consultants share the construction risk.

LIABILITY

The legal outcome of a joint acceptance of all risks is that the participants mutually release each other from legal liability for negligence, breaches of contract (other than wilful breaches) and other legal liabilities. Generally that release will include the circumstances where a third party institutes a claim against an alliance participant. That particular circumstance in detail in the next section.

The most significant aspect of this mutual release relates to design. The owner must effectively surrender his legal recourse against the designer (and contractor) for defective design.

Of course, if the defect is discovered during construction, rectification costs will become project costs, shared by all participants. However, after completion, the owner will generally have no recourse to the other parties if a design defect is subsequently discovered.

The trade off is that the designer in particular is freed from the spectre of subsequent legal action and is better able to contribute 'best for project' design.

There are, however, several caveats to general liability release.

Legislative rights

There are some rights bestowed by legislation which, by the terms of the particular legislation, cannot be given away. One relevant example section 52 of the *Trade Practices Act* which prohibits corporations from engaging in misleading and deceptive conduct. A right to sue for a breach of that section cannot be varied or abrogated by contractual agreement.[8] It will still be possible for an alliance participant to claim damages against another for misleading and deceptive conduct which constitutes a breach of the *Trade Practices Act*. It is not difficult to imagine where an alliance ends in acrimony, that creative lawyers will be able to identify conduct which may be, objectively, misleading.

Fiduciary duties

If, as discussed above, the participants owe each other fiduciary duties, a breach of those duties will provide an enforceable right of action against the offending party. Of course, negligent conduct would not normally be sufficient to constitute a breach.

The insurance overlay

Until quite recently, the primary risk management tool of most owners, contractors and designers was a transfer of risk through insurance policies. The premiums were relatively cheap and insurance was readily available.

However, the face of the world insurance market has dramatically changed in the past few years. In addition to the fall out from the September 11 catastrophe, we have seen the collapse of HIH and the revelation that many insurance companies have been under reserving and under pricing insurance for a decade or more.

The construction industry has not been protected from the fallout. Insurance is now much less available, and when it is available it is much more expensive. The use of insurance must now be much more judicious and owners and contractors need to focus much more attention on other risk management strategies.

For an alliance, the issue is critical. The unavailability of insurance, in the absence of acceptable alternative risk management strategies, are capable of completely derailing an alliance project.

The table below sets out, conceptually, how the major risk categories are insurable during each distinct phase of the alliance.

[8] *Clark Equipment Australia Ltd v Covcat Pty Ltd* (1987) 71 ALR 367

Phase	Works Damage * Fortuitous Event	Works Damage * Construction Defect	Works Damage * Design Defect	Third Party Claim (Injury/Damage)
iPAA	N/A	N/A	N/A	Individual PL and PI policies
PAA	Contract Works Policy	No cover available **	PI?	Project PL policy (defective design and work excluded)
Defects Liability Period	Works Policy or ISR policy	No cover available **	PI?	Project PL policy / individual PL policies (defective design and work excluded)
Operation	ISR Policy	No cover available **	PI?	Individual PL policies (defective design and work excluded)

(* including financial losses)
(** cover is generally available for 'resulting' loss or damage)

It is immediately apparent that the major gap lies with defective design and construction. Defective construction can, by and large, be accommodated within the alliance through defect rectification processes.

The spectre of a defect in design creates more significant problems. Until recently, that gap was filled by a special project professional indemnity policy which funded, on a no liability basis, the cost of rectifying the work (and often consequential losses) arising from a design defect. That insurance is now unlikely to be available. Where it is, the premiums will almost certainly be far too expensive.

This presents a major exposure for the owner, particularly where the design defect is not detected (or does not cause loss) until after final completion. If the defect become apparent during construction, rectification will be an alliance cost (although, of course, the cost may well be so significant as to take it well beyond the magnitude of the amounts 'at risk' for non owner participants).

Without insurance, the owner is left to depend on the adequacy of the quality assurance and verification processes adopted and implemented by the alliance.

A similar gap exists in relation to liabilities to third parties (external to the alliance) where those liabilities arise principally through a defect in design. Most external liabilities will be within the ambit of public liability insurance. However those policies rarely respond to events precipitated by design defects. That gap has traditionally been filled by professional indemnity insurance but that is not the case in an alliance context for the reasons set out above.

Without a project PI insurance policy, all of the participants need to consider carefully what the ramifications may be by particularly in relation to claims made after completion.

Indeed, it is not only the participants who will take an interest in the consequences of a claim in these circumstances. Their own insurers (for public liability, business interruption and advance loss of profits) are likely to express discomfort where all liabilities between participants are released, including the liability to contribute to third party claims.

The options available to the participants are:

1. No insurance

The participants could agree that, notwithstanding the absence of collective professional indemnity insurance, full releases will still be given by each participant to the other with respect to all matters including claims brought by third parties which arise out of design defects.

This option is the most faithful to alliance principles, but potentially exposes each participant to the risk of being sued by a third party for a decision made collectively by the alliance, but with no prospect of being able to join other alliance participants in the legal proceedings.

This problem is best illustrated by example. After the completion of the construction of a gas pipeline under an alliance, a compressor explodes during routine maintenance because of a fault in design. One of the injured maintenance workers sues the owner of the pipeline. Because of the release of liabilities clause in the alliance agreement, the owner cannot join either the contractor or the designer as a third party and has no effective legal recourse to either of them.

2. External design verifier

One of the more creative proposals to overcome the lack of alliance insurance in relation to design defects is for the alliance to appoint an external design verifier to warrant that the design is fit for its purpose. The theory is that, if a claim is subsequently made because of a defect in design, the design verifier can be joined as a third party or defendant and presumably will be covered by his or her own professional indemnity insurance.

It seems unlikely that an external engineer (or his or her insurer) would be prepared to assume the entire risk of the design of the project on the basis of design verification. However, even if that were possible, and the verifier later sued for a design defect, the verifier is still in a position to join one or more of the alliance participants for contributory negligence. That leaves the alliance participant who has been joined by the verifier in the same position as in option 1.

3. Preserve some liability

Although it partly compromises the collective 'no blame' philosophy of alliancing, one practical way of overcoming the concerns expressed above is for the mutual releases to be qualified where a claim is made by a third party against an alliance participant for an injury or loss which is predominantly caused by professional negligence. In those circumstances, the parties agree that they are liable to each other for their own professional negligence, enabling a party who has been sued by a third party to seek contribution or an indemnity from other alliance participants.

If those liabilities are preserved, then the professional indemnity insurance of each of the participants should also be available to respond to claims arising from defective design.

Although this 'carve out' from the participants' mutual releases is usually restricted to circumstances where a claim is made by a party external to the alliance, it would be possible to extend the 'carve out' where one of the alliance participants (most relevantly, the owner) has itself suffered loss arising through professional negligence.

Of course, the effect is to preserve separate liability for design and that represents a significant erosion of the 'no blame' principles which usually underpin alliancing.

Rights against third parties

Particular care needs to be taken, in establishing an alliance, to ensure that rights against third parties for breach of contract and negligence are fully preserved and that the correct participant or participants are the beneficiaries of that right. For example, if only the contractor engages a consultant or subcontractor, any warranties that are given by them are given only to the contractor unless specific reference is made to the other participants in the alliance. Because there is no liability between the participants, there is no chain of contractual liability that links the owner (who is most likely to suffer loss) with the consultant or subcontractor.

Accordingly, consideration should be given to ensuring that all participants, collectively, engage subconsultants and subcontractors, or alternatively, that the contracts with those parties specifically acknowledge that warranties are given in favour of all alliance participants (or at least the owner).

VARIATIONS

Under most conventional project delivery methods, a variation to the original scope of work will trigger an adjustment to the contract price. Although it is common to find the parties disputing whether or not the variation has or has not occurred and, if it has, what the appropriate contract price adjustment should be, those issues are, ultimately, questions of fact which can be determined objectively.

Even with GMP cost reimbursable contracts, an increase in the scope of work will trigger an increase in the GMP.

In contrast, under a typical alliance contract, only 'substantial' or 'material' variations may result in an adjustment to the target cost, and even then, only where the alliance board considers it appropriate that an adjustment be made. The board is frequently called upon to make that assessment against the background of an alliance goal of no variations. There is a far greater level of subjectivity in the assessment of the impact of variations.

For these reasons, it is crucial that the alliance participants be fully aligned on the nature of variations that should and should not result in adjustments to the target cost. That alignment is frequently achieved through a variation benchmarking the process conducted the feasibility phase. During the benchmarking process, the alliance reaches a collective agreement as to whether or not an adjustment to the target cost is warranted in a range of different scenarios.

Having done that benchmarking exercise, there is often debate between the participants as to whether the benchmarking ought to have contractual stages or whether it should simply be regarded as a document to which reference can be made by the board in appropriate circumstances.

Although the introduction of the benchmarking into the contract will go some way to adding a level of predicability to variation assessments, it will inevitably inhibit the discretion given to the board to deal with variations as and when they arise. This can conceivably cut across the board's primary focus on 'best for project'.

For these reasons, the temptation to give variation benchmarking #contractual# status should be resisted.

COMPLETION

As with conventional contracts, most alliance agreements contemplate both practical completion and final completion as formal milestones.

The 'control' of these milestones and defect rectification is generally left in the alliance board - it will issue defect notices and issue the certificates of completion. That is a significant surrender of responsibility and control by the owner.

Some alliances reserve for the owner the right to issue a defect notice and to unilaterally arrange for urgent rectification work to be carried out. The latter is advisable for practical reasons, particularly following handover of the facility and demobilisation of the alliance team from site.

Final completion usually triggers a full release by the owner of any existing or future liability. It signifies the end of the alliance.

Thus, the owner is left with full responsibility for latent defects which are subsequently discovered. Unlike most standard construction contracts, latent defects are not usually excluded from the final release. The rationale is that final completion should signify the end of the alliance and the acceptance by the owner of all future risks of the asset.

For some projects there is a case for preserving joint liability amongst participants for latent defects, by, for example, enabling the owner to reopen the alliance incentive payments to bring to account the cost of rectifying latent defects. Of course, the owner's first recourse should be subcontractor warranties.

Late Completion

Generally, late completion will have a negative impact on the incentive payments of non-owner participants. That 'penalty' is more consistent with alliance principles than the imposition of liquidated damages.

However, where there are significant financial consequences to the owner of late completion, some thought needs to be given as to whether the participants collectively should bear those consequences. For example, if late completion exposes the owner to upstream damages to customers, should those damages be brought to account as costs of the alliance?

DISPUTE RESOLUTION

The liability release usually found in alliances will, except in cases of fraud and wilful breach, remove the prospect of litigation between parties in respect of negligence and contractual breach. There are, however, other disputes that may well arise. For example:

- should a particular variation lead to an adjustment of the target cost estimate?
- has practical completion been achieved?

In those circumstances, the resolution of the issue is generally left to the Board, or perhaps senior executives of the parties. A failure to agree at those levels creates an impasse for which there is no agreed mechanism for resolution.

A deadlock breaker?

Lawyers dislike and disapprove of the absence of deadlock breaking clauses. But that should not necessarily discount the concept of forcing the parties to resolve disagreements internally.

However, there are some disputes which need to be resolved to enable the project to progress and consideration should be given, for those disputes, to prescribing an acceptable resolution process in the alliance agreement.

For example, where the board cannot agree as to whether practical completion has been achieved, it may be prudent to include a speedy adjudication process to resolve the impasse. It is an issue which is sufficiently objective to enable an independent determination to be made.

Court intervention

It would be a mistake to assume that the usual covenant against litigation will prevent the parties from commencing court proceedings to enforce rights under the alliance.

Judges have a long-held dislike for attempts through contractual clauses to 'oust' the jurisdiction of the courts.[9] It is said to be against public policy and unenforceable. Accordingly, an alliance participant will always be able to seek the court's assistance to, for example, overrule the Alliance Board's decision in respect of a variation or limb 3 compensation calculation which, arguably, has failed to implement the provisions of the alliance agreement.

Notably, there are no reported cases in Australian courts which have arisen out of an alliance. That is a testimony to the success of alliancing to date in Australia.

CONCLUSION

It is important not to throw the baby out with the bath water.

There are undoubtedly some legal issues to carefully consider in creating the legal framework for an alliance. But those issues should be considered in the context of the paramount objectives of the alliance. Most of them can be appropriately resolved without damaging the fundamentals of alliancing.

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[9] *Dobbs v National Bank of Australasia Ltd* (1935) 53 CLR 643.