Alliance Contracts and Insurance

Introduction

Alliance contracts offer a unique system of project delivery whereby risks are shared between principal and contractor. There are substantial benefits associated with this procurement option, testimony to which is the exponential growth of such contracts by federal, state and local government. Despite the enthusiastic adoption and growth in the use of alliances, there are tangible disadvantages of such contracts that warrant consideration. In particular, the alliance literature and contemporary practice indicates that the provision of insurance tailored for a pure alliance is difficult to obtain or cost prohibitive. This paper explores this perception by comparing the insurance available for alliances with a comparison to the insurance appropriate to a traditional fixed price contract.

Methodology

My investigation involved a focused review of a very small sample of insurance products and a small sample of interviews with insurance brokers. This precludes a quantitative analysis of results in lieu of a qualitative analysis. The nature of the research is exploratory in nature, focusing on the question of, 'what is the insurance environment for alliances?' A triangulated approach is adopted in this research exercise. I firstly conducted a review of the terms and conditions of a contemporary alliance contract insurance policy and a traditional contract insurance policy. In concert, I interviewed three senior managers from an insurance broker who specialises in the procurement of alliance contract insurance. The analysis from these two sources is compared to the alliance literature and my previous interview responses from 26 alliance managers to conduct a comparative analysis of what the insurance environment actually is compared to how this environment is perceived by alliance practitioners.

The Perceived Problem of Alliances and Insurance

Associated with the cost of 'paying' for contractor mistakes and a framework of 'no liability' is the concern that professional indemnity insurance[1] is very difficult to obtain or may not be available for work conducted under a pure alliance. The presence of a no-disputes clause in a pure alliance results in no alliance partners being liable for any losses (except for wilful default). Thus conventional liability-based

[1] Public liability insurance also presents unique challenges with alliances though this is manageable and far less a concern than the issue of professional indemnity insurance; Victorian Government Department of Treasury and Finance, 'Project Alliancing Practitioner's Guide' (2006), 63; See also Chew, 'Alliancing in Delivery of major infrastructure Projects and Outsourcing Services - An Overview of Legal Issues' (2005), 11-12, who describes the benefits of a project specific public liability insurance policy

insurance will be ineffective as no liability arises.[2] Standard insurance will therefore offer the alliance owner little comfort and either special insurance must be obtained or deviation from the pure alliance, 'no liability' regime must be pursued.[3] A perception exists that obtaining project specific professional indemnity insurance within a no-liability framework is a challenging task in Australia[4] and where such insurance can be sought, it is perceived to be prohibitively expensive.[5]

Ross recommends the following strategies be considered in obtaining professional indemnity insurance under an alliance:[6]

a. adopt a very large excess for the insurance cover (e.g. $1m),

b. implement robust risk management practices, and

c. provide insurer representation at key project milestones.

An alternative approach is to adopt self insurance. Self insurance may be desirable where design risks are manageable. Furthermore, the reimbursement model of the alliance inherently manages this risk with the designer's limb 3 compensation being at risk from design errors. The challenge for government with self-insurance is with respect to insurance coverage after final completion of the project (post award of all limb 1, 2 and 3 fees). If latent defects in the design or construction elements of the project are discovered after final completion then government's options for recovery are limited, as no liability exists between alliance participants. This may prove highly undesirable where the integrity of delivered project is unable to be fully verified at final completion. Hence, where self-insurance is inappropriate, the alliance must pursue one of the following:

a. the alliance relationship must be modified to provide some liability with the design and/or construction elements such that conventional insurance may be sought; or

b. project specific insurance must be obtained to provide cover for 'first party' loses arising from breaches of professional duties between alliance participants. [7]

Considering the first option, several alliances do deviate from the pure alliance model to facilitate conventional professional indemnity insurance. This has lead to the

[2] Rehana Box, 'Why Project Alliances Need New Insurance Products' (2002) ANZIIF Vol 25 Number 2, 29.; Owen Hayford, 'Ensuring your Alliance Contract is legally Sound' (2004), ACLN Issue 99, 50. Chew, 'Alliancing in Delivery of major infrastructure Projects and Outsourcing Services - An Overview of Legal Issues', 11; Andrew Stephenson, 'Alliance Contracting, Partnering, Co-operative Contracting – Risk Avoidance or Risk Creation'(2000) paper presented to Clayton Utz Major Projects Seminar, October 2000, [5.3]; Victorian Government, above n 1, 63.

[3] J. Ross, 'Introduction to Project Alliancing' (2003) Alliance Contracting Conference Sydney October 2003, 1 at www.pci-aus.com, 13-4.

[4] Stephenson above n2 , [5.3].

[5] Victorian Government above n1, 62; Ross above n2, 14; Chew, 'Alliancing in Delivery of major infrastructure Projects and Outsourcing Services - An Overview of Legal Issues' n2, 11.

[6] Ross above n2, 14.

[7] Victorian Government, above n 1, 63.

development of the 'project alliance'.[8] The 'project alliance' deviates from the pure alliance model by maintaining strict liability between the alliance owner and the alliance contractor. This alliance model provides access to insurance post-alliance[9] where latent defects may be discovered in the project works. It should be recognised that where liability is maintained between alliance participants, there is increased risk that the collaborative nature of the alliance may be diluted[10] as well as reduced pressure on the drive toward innovation.[11] The acceptance of these costs need to be considered in the context of project risk (the likelihood and consequence of latent defects occurring) as well as government's obligations to support the delivered works after final completion. If government is averse to adopting a project alliance delivery model, then the second option must be pursued, being the procurement of project specific insurance.

Insurance Tailored for Alliance Contracts

If self insurance and deviation from a pure alliance model is undesirable, then the alliance must procure project specific insurance for 'first party' loses. The alliance literature and comments provided during my interviews reveal that such insurance policies are considered difficult to obtain or prohibitively expensive. Despite this rhetoric, such policies are readily available and the author is aware of alliance insurance being applied on 15 alliance contracts.[12] One insurance broker specifically markets 'no liability' insurance products for alliances.[13] These policies may be triggered by one of two events:

a. claims against third parties (for example sub-contractors); or

b. claims against the alliance itself for defective workmanship.

The scope for this project specific insurance cover is broad and offers recourse for failure to achieve 'fitness for purpose'.

My two main areas of investigation, is firstly whether the alliance 'project specific' insurance provides comparable cover to that of a traditional contract or alliance contract that maintains strict liability between participants and secondly, whether this cover is cost effective.

Review of Alliance Professional Indemnity Insurance

A review of an alliance insurance policy and responses from insurance brokers reveals that there is little difference between traditional professional indemnity insurance cover and that of an alliance professional indemnity insurance policy. Both provide

[8] Brad Cowan & John Davies, 'Development of the 'Competitive TOC' Alliance - A Client Initiative' (2005) <http://www.alliancenetwork.com.au/white_papers.html>, 3.
[9] Ibid, 4.
[10] Ross, above n3, App 2.
[11] Hayford, above n2, 50.
[12] Information provided during interviews with insurance brokers
[13] http://www.aon.com.au/corporate_government/specialisation/construction.asp

coverage for defective work during and after project delivery. Similarly, both provide cover for services provide by third parties such as suppliers and sub-contractors. There is, however, authority to suggest that the insurance cover provided under a pure alliance arrangements is less robust than traditional PI insurance.[14] To critique this assertion, I compared the main areas of a pure alliance insurance policy to that of a traditional contract in the following areas:

a. scope of insurance,

b. triggering mechanisms,

c. insurance cover run off,

d. insurance provisions for wilful default,

e. insurance for liquidated damages,[15]

f. insurance against adverse site conditions, and

g. insurance against force majeure.

Scope of Insurance. The alliance insurance policy provides; 'insurance against losses incurred or suffered as a result of acts, errors or omissions which are a breach of professional duty.'[16] This provides the same scope of cover to that of a traditional insurance policy though there are some subtle differences. In a pure alliance, extensive risk management activities are conducted at the start of the project to quantify the target cost and target schedule. These estimates cater for risks that are shared by the alliance owner and non-owner participants. When insurance is procured, the alliance, in conjunction with the insurer, negotiate the transfer of some of the project risks via an insurance policy. This ensures that no risk is jointly covered in the alliance painshare/gainshare arrangements and in the insurance policy (thus avoiding the problem of redundancy). This collaborative arrangement therefore deviates from traditional insurance mechanisms, though the end result is the same, that is, coverage for losses stemming from acts, errors and omissions of professional duty.

Triggering events. A traditional insurance policy is typically triggered by one party against another. For example, a principle may initiate a claim against the contractor. Such triggers are commenced unilaterally. An alliance insurance policy allows for 'first party' claims initiated by the alliance itself.[17] In practice, it is the alliance leadership team through the alliance chairman that initiates a claim. This requires unanimity between the alliance participants for a claim to be made. Provided the alliance participants operate in good faith and adopt best for project principles, this

---

[14] NSW Department of Commerce 'Procurement Method Selection' (2007) 16, at www.managingprocurement.commerce.nsw.gov.au/procurement_method_selection/ps_contract_systems.doc

[15] Despite the fact that liquidated damages clauses are absent in alliance contracts (as they are offensive to alliance behaviours) traditional contracts may provide cover in this area.

[16] Professional Indemnity Insurance Policy for Alliance Construction Projects, cl 1.3.

[17] Professional Indemnity Insurance Policy for Alliance Construction Projects, cl 5.1.

arrangement should offer no challenges. Furthermore, the alliance insurance policy names the alliance itself as the insured rather than each individual participant, hence 'blame' for the insurable loss is not assigned to any individual organisation. Notwithstanding, there may be reluctance from the non-owner alliance participants to initiate a claim for the following reasons:

a. pursuit of a claim may tarnish the non-owner alliance participant's claim record resulting in higher premiums for future projects;

b. an adverse claims record may jeopardize the competitiveness of future bids by that alliance participant, especially when future principles consider 'claims record' as a tender evaluation criteria; [18] and

c. Payment of the insurance excess is likely to impact on the gainshare/painshare arrangements thus jeopardising non-owner alliance participant's profit.

Despite the tensions created by the above, it is important to recognise that if a claim is not made then any losses are likely to be extracted from the alliance gainshare provisions. There will be a temptation, however, for the non-owner alliance participants to argue that the claim results from an issue out of scope of the alliance agreement and thus the non-owner alliance participant is not liable. This would be of considerable concern after practical completion when the alliance relationship largely ceases. This risk has been recognised by insurers with the inclusion of provisions for the alliance owner being able to trigger claims unilaterally after practical completion of the alliance works. To this end, there is no compelling argument to suggest that alliance insurance claims are more difficult to trigger than traditional insurance claims.

Insurance Cover Run Off. The run off period for alliance insurance is no different to that available for traditional insurance. Interviews with alliance insurance brokers indicated that run off periods from seven to ten years from project commencement are available and that extensions to these durations are negotiable. The ability for the alliance owner to unilaterally trigger a claim after practical completion provides cover for latent defects beyond traditional warranty periods.

Insurance for Wilful Default. Wilful default is an event recognised in alliance contracts that give rise to legally enforceable remedies. Insolvency of a non-owner participant is considered by most alliance contractors as a wilful default or event with the same consequences as wilful default. Insolvency is discussed in detail below. Neither a traditional insurance policy nor alliance insurance policy will provide cover for wilful default or insolvency. Notwithstanding, both policies offer insurance cover for acts of fraud or dishonesty. This requires further investigation as there is no specific definition of fraud provided in each policy. This is relevant because an alliance is likely to give rise to fiduciary obligations between alliance participants and thus there is scope for events to result in equitable fraud or constructive fraud. The

[18] QLD Department of Main Roads, 'Main Roads Project Delivery System Vol 2: Tendering for Major Works' (2005) App C; 'Tasmanian Government, Department of Treasury, 'Guidelines on Tender Evaluation using Weighted Criteria for Building Works and Services' (2006) 5; Building Contracts Australia, Alliance Contracts [64,035] 2.4 'Soft Selection Criteria'.

consequences of such events and how insurance caters to such events warrants further consideration.

Liquidated Damages. Liquidated damages are abhorrent to alliancing principles as this involves discrete risk transfer from the alliance owner to non-owner participants. In lieu of liquidated damages, the alliance relies on gainshare/painshare provisions with schedule related key performance compensation to ensure timely delivery of a project. In the absence of insurance, the risk of late delivery and attendant delay costs is therefore a risk shared between all alliance participants. An alliance insurance policy on the other hand, provides cover for losses resulting from delayed delivery of a project[19]. This effectively provides comparable protection to that offered by liquidated damages provisions in traditional contracts. In fact, the protection offered by alliance insurance for losses is likely to be more robust as liquidated damages claims often suffer from the challenge of the principle proving that 'their hands were clean' to be successful in claiming for such damages. To this end, alliance insurance policy offers equivalent, if not better protection than that associated with traditional liquidated damages protection.

Considering the above elements of insurance, the alliance insurance policy offers no substantial disadvantages to that of a traditional contract insurance policy. In some areas, the alliance policy is superior. What I must now consider is the cost of alliance insurance policies, excesses and hidden costs.

Cost Effectiveness of Alliance Professional Indemnity Insurance

Though the scope of professional indemnity insurance for alliance contracts may be comparable to that of traditional professional indemnity insurance, whether this alliance insurance is cost effective remains a separate question. The 'soft' insurance market[20] and availability of a number of insurers providing 'first party' alliance specific insurance is an indicator supporting the premise that alliance insurance is competitive.

Interviews with alliance brokers indicate that alliance insurance premiums are comparable to that of traditional contracts. It is not possible to provide a benchmark for insurance premiums as a percentage of the contracted works as each individual project comprises unique risks and profiles that affect premiums. Notwithstanding, several alliances have procured professional indemnity and public liability insurance for premiums around one percent of the total project value. This is consistent with that of traditional contracts. A cynic could argue that this premium should be less as the alliance effectively self insures against many losses through gainshare/painshare arrangements. This is a valid criticism, though such views should be tempered by the fact that alliances are typically applied to high risk projects and insurance premium

[19] Note that the scope of delay must not be from a risk incorporated into the alliance target cost and schedule i.e. a trigger for claiming this loss must be from a risk that was adopted by the insurer from the onset.
[20] KPGM 'Record profits, greater diversity of performance and tougher times ahead for general insurers' (September 2006) at http://www.kpmg.com.au/Default.aspx?TabID=209&KPMGArticleItemID=2188.

must reflect this risk. If the construction risk of a project was low then the motivation for using alliances in the first place is weakened.

Interviews with insurance brokers also confirmed that the alliance insurance policy excess is comparable to that of a fixed price contract. These brokers also confirmed that there is a trend for reducing excesses as more insurers enter the alliance insurance market and become more 'comfortable' with alliance principles.

Hidden Costs of Alliance Insurance?

Even if the alliance insurance direct costs (premiums and excesses) are comparable to traditional insurance costs, I must make a comparison to the 'hidden' costs of gaining insurance, for example:

a. Does the alliance specific insurance policy introduce additional administrative costs (workshop presentations to insurers, additional risk management plans, greater negotiation imposts on subcontractors);

b. Will insurers impose special conditions onto the alliance participants; and

c. Will conditions be imposed during the insurance run off period?

I examined the process for procuring alliance insurance during my interviews with alliance insurance brokers. To summarise, there is little difference between the process used to obtain insurance between traditional contracts and alliances. For alliances a workshop is typically conducted between the alliance participants and the insurer to quantify project risks and allocate those risks to either the alliance or the insurer via a risk and opportunity register. This activity is germane to most alliances and therefore does not impose additional costs. In addition there are no special conditions imposed on alliance participants or conditions in the run off period that deviate from a traditional contract insurance policy.

There is only one area where the hidden costs of an alliance insurance policy may eclipse that of a traditional contract and that is related to variations. Both traditional and alliance insurance policies demand the reporting of any 'material changes to risk' within 30 days.[21] Variations are managed formally and generally infrequently in a traditional contract via contract change proposals. The alliance, on the other hand provides the alliance leadership team with substantial discretions to pursue variations and thus alter insurer's risk. This may demand increased negotiations with insurers and revaluation of insurance premiums throughout the project. This may therefore impose additional administrative costs to the alliance. How insurers treat variations in an alliance will require further investigation before these administrative costs may be quantified.

[21] Professional Indemnity Insurance Policy for Alliance Construction Projects, cl 6.1

Exclusions and Protection Against Insolvency

Also worthy of consideration is government insuring or protecting itself against the risk of alliance participants becoming insolvent. This risk is not parochial to alliances but also applies to traditional delivery methods. Specific insurance against the risk of insolvency is currently not available in Australia and Principles typically protect themselves against this risk by demanding a bond be lodged by contractors to cater for contractor default or a guarantee be provided for such loses.

The author is aware of two alliance projects where an alliance participant became insolvent. It is inconceivable to imagine the liquidator of an insolvent alliance participant adopting 'best for project' principles; hence government may wish to protect themselves against such an outcome for the following reasons:

a. Insolvency may trigger a need to conduct a new tender evaluation (at considerable cost to government);
b. Insolvency will incur demobilisation costs for other alliance participants and mobilization costs for a replacement alliance partner; and
c. Insolvency may trigger rework of critical project activities to satisfy the requirements of the new alliance participant (or at least substantial verification and validation).

The insolvency of Walter Construction group during the Burnett Dam alliance and the Bondi Reliability Improvement and Modernisation Program proved a catalyst for the consideration of protection for insolvency of alliance participants. More specifically, this was an express condition in Toowoomba City Council's Wetalla Wastewater Treatment Plant Alliance. As a local government conducting a high value project ($32million), the risk of an insolvent alliance participant was deemed to be extreme hence the pursuit of this type of protection via guarantee was justified. At first instance, however, alliance participants felt that such a condition was not in the spirit of alliancing. This perspective should be tempered by the fact that insolvency is tantamount to a wilful default.

The emergence of Contractor Default Insurance (CDI) in the USA in 1996[22] is an initiative that may be of consideration for Australian alliances. Such policies may prove more cost effective than bonds or guarantees and since, contractor default insurance is a 'first party' policy product, the recovery of losses may be more timely. It is important to recognise that CDI policies are tailored to protect main contractors from acts and omissions by suppliers and sub-contractors. This arrangement may require tailoring to cater for an alliance structure so that the alliance owner can claim for loses stemming from the insolvency of an alliance participant. In addition, CDI may offer more robust protection when compared to guarantees as the variation management process in alliances is likely to alter the sureties obligations and render a guarantee unenforceable.[23] This is especially so where an extension to time is provided which is likely in an alliance. [24]

---

[22] http://www.surety-canada.com/contractors/riskcon.html
[23] See esp *Halsbury's Laws of England*, 4th ed Vol 20, 141 and *Ankar Pty Ltd v National Westminster Finance (Aust) Ltd* (1987) 162 CLR 546,551; *Corumo Holdings Pty Ltd v C Itoh Ltd* (1991) 5 ACSR 720.
[24] J. Phillips & J. O'Donovan, *Modern Contract of Guarantee 4th Ed* (1992) 215.

Proportionate Liability Legislation

Proportionate Liability legislation has been introduced to all states and territories.[25] The effect of Proportionate Liability Legislation is that claims cannot be brought against a party where that party was not solely responsible for loss.[26] This is reflected in the following Queensland legislation:

> 31 Proportionate liability for apportionable claims
>
> (1) In any proceeding involving an apportionable claim--
>
> (a) the liability of a defendant who is a concurrent wrongdoer in relation to the claim is limited to an amount reflecting that proportion of the loss or damage claimed that the court considers just and equitable having regard to the extent of the defendant's responsibility for the loss or damage… [27]

There are few options available for the parties of a contract to avoid the operation of proportionate liability legislation. Whilst the Western Australian legislation provides a simple means to avoid proportionate liability,[28] the only other practical means of avoiding the legislation in other Australian jurisdictions is to invoke final and binding arbitration or adopting foreign law in the operation of the contract.[29] Final arbitration is abhorrent to the pure alliance philosophy and this would not provide relief from proportionate liability legislation applying from claims by third parties.

The operation of proportionate liability legislation appears to have been considered by alliance practitioners. Contemporary alliances explicitly carve out claims from third parties:

> **25.2 Indemnities (third party claims)**
>
> 25.2.1 Subject to clause 25.2.2 each Participant (the "Indemnifier") agrees to indemnify the other Participant (each an "Indemnified Participant") against:
>
> a) claims by a third party; and
>
> b) liability to a third party,

---

[25] Trade Practices Act 1974 (Cth) 87CD; Civil Liability Act 2003 (Qld), Civil Liability Act 2002 (NSW), Wrongs Act 1958 (Vic), Civil Law (Wrongs) Act 2002 (ACT); Civil Liability Act 1936 (SA); Building Act 2000 (Tas); Civil Liability Act 2002 (WA).
[26] A G Uren, D. Aghion 'Proportionate Liability: An Analysis of the Victorina and Commonwealth Legislative Schemes'Commercial Bar Association Paper for CLE Seminar 18 August 2005, 14-5.
PROPORTIONATE LIABILITY:
AN ANALYSIS OF THE VICTORIAN AND COMMONWEALTH
LEGISLATIVE SCHEMES
[27] See eg. Civil Liability Act (2003) QLD s31.
[28] Andrew Stephenson, 'Proportionate Liabilty in Australia – The Death of Certainty in Risk Allocation in Contract' ICLR 2005, 90.
[29] Ibid.

> for damage to property or death or bodily injury arising out of or as a consequence of any act, error or omission of the Indemnifier in the performance of its Work under the Alliance whatever the cause, including breach of this PAA, tort (including negligence) or breach of statute or otherwise.[30]

Consequently, alliances of this form will not attract adverse outcomes from proportionate liability legislation, albeit alliance participants must maintain insurance policies, severally, for claims made by third parties.

Where proportionate liability legislation may cause mischief within the alliance is when the alliance owner suffers a loss from the acts or omissions of an alliance sub-contractor. For example, if a non-owner participant contributed to the loss then conceivably, the non-owner's proportionate liability may not result in an adjustment to the alliance Target Cost.[31] The consequences of which is that the alliance owner solely accepts this risk. To avoid this situation, alliance agreements may explicitly state that losses apportioned to alliance participants will result in adjustment of the target outturn cost. This is consistent with the risk sharing philosophy of the alliance.

Conclusions

Despite the adverse perceptions associated with alliance insurance costs and availability, such products are readily available and are cost effective. There are practically no substantial disadvantages between the cover afforded by a conventional fixed price construction insurance policy and that offered by an alliance insurance policy. In some instances, the alliance insurance policy offers more robust protection especially for losses incurred from schedule delays (equivalence to liquidated damages). The only areas of concern with alliance insurance would be the management of non-owner alliance expectations with the pursuit of claims prior to practical completion. Though this is a low risk, there may be tensions created by non-owner participants being reluctant to pursue a claim if it adversely affects their claims record. Whilst alliance insurance appears to be priced competitively to traditional insurance with no additional administrative costs of significance, the management of variations needs further consideration to establish what insurer's expectations are with respect to a 'material change of risk'.

The author is aware of many alliance projects (some as recently as April 2007) that have pursued a 'project alliance' as a means of procuring project insurance. This justification and the majority of the alliance literature surrounding alliance insurance is invalid as cost effective contemporary alliance insurance can be procured for pure alliances on a 'first party' claims basis. As the alliance insurance industry matures, it would be expected that these policies become even more competitive with reduced premiums and policy excesses. There is therefore no compelling reason to eschew alliancing for reasons related to project insurance.

---

[30] Newcastle Rail Corridor Project Alliance Agreement (PAA) ME_70164874_1 (W2003) & 163065_10, cl 25.
[31] Ian Brigss, 'Consequential losses – a Can of Worms for Alliances' (2006) 4.