

Legal considerations of alliance contracts

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1 An overview of alliancing

Alliancing is a co-operative form of contracting where the participants enter into a relationship, called an alliance, which is designed to align the commercial interests of the participants. Each participant in the alliance will share in the success or failure of the project and in the decision making and risk management.

Alliancing began in the construction industry in North Sea oil and gas projects in the early 1980s as a result of dissatisfaction with traditional project delivery methods. Currently, alliancing is one of the most commonly used alternatives in Australia to the traditional project delivery methods.

2 Risk profiles of alliancing compared with traditional project delivery methods

2.1 Introduction

Determining the way in which a project will be delivered is one of the most crucial tasks when carrying out a project. It is important to ensure that an appropriate project delivery method is used, having regard to the various factors relevant to the particular project. Such considerations include:

- (a) the major risks associated with the particular project;
- (b) the level of control which is to be exerted by the project owner, particularly in relation to the design development and construction and commissioning processes;
- (c) the time constraints on the project delivery;
- (d) the experience and capability of project participants to deliver the project optimally taking into consideration cost, time and quality;
- (e) the capabilities of the project owner, including the level of familiarity with design and construction;
- (f) the complexity and size of the project; and
- (g) stakeholder inputs (eg project financing).

When choosing a project delivery method, project participants can choose between the more traditional, adversarial-style contract delivery methods or

adopt the more innovative “relationship-contracting” delivery methods, which includes alliancing.

2.2 What are the traditional forms of project delivery?

The traditional forms of delivery methods are:

- (a) construct only contracts;
- (b) design and construct contracts; and
- (c) construction management and project management agreements.

The trend in the construction industry is for the party with the stronger bargaining power (usually the project owner) to shift the onus of responsibility of risk under a contract onto other parties to the contract. Such risk shifting causes the financial interests of the parties to become opposed from the start of the project.

A standard construct only delivery method involves the development of the design for a project by consultants retained by the project owner. Following the development of the design, a contractor is engaged by the project owner to construct the project in accordance with the principal’s design. This type of method may be carried out on a lump sum or schedule of rates basis. The advantages of this type of contract include that the contract will provide for how risk is to be allocated, the principal can select the design consultant and ensure design is completed before commencement of the project and a contract administrator will control quality and deal with contract administration issues. The disadvantages of this method include the long time from initial concept to practical completion, the limited scope for “value adding” by the contractor and there is no single line of responsibility (for example, as the contractor is not involved in the design, it is often difficult to determine whether a defect arises due to design or construction).

A design and construct delivery method will usually involve the project owner preparing a design brief which outlines the key requirements of the project, such as a description of the works and the performance requirements of the project. The contractor will be responsible for designing the project on the basis of the project brief and constructing the works in accordance with that design. The contractor will be remunerated on the lump sum basis. The main advantage to the project owner is that the contractor has overall responsibility for designing then constructing the works and the contractor will be responsible whether the fault is due to a design or construction defect. The main disadvantages are that there is a need to adequately define the scope of works in the project brief in order to reduce the number of variation claims, the opportunity exists for the contractor to “under-design” part of the project in order to increase its margin and there is often a lack of financial incentive to complete the project early.

The construction management and project management delivery methods involved the contractor providing management services to the project owner and the project owner contracting directly with the trade contractors. The advantages of these methods include the project being managed by one party from beginning to end and the project owner being able to retain control of

the project through its direct contractual link with the trade contractors. However, such contracts are usually administratively complicated, expose the project owner to construction risks via the direct contracts with the trade contractors and, unless adequate cost management mechanisms are included, the project owner may lose control of the cost of the project.

2.3 What is relationship contracting?

Relationship contracting is defined by the Australian Constructors Association as “a process to establish and manage the relationships between the parties that aims to remove barriers, encourage maximum contribution and allow all parties to achieve success”. Relationship contracting evolved from the need to bring projects to completion earlier, at a lower cost and pursuant to a more efficient “risk and reward” allocation system. A key element in relationship contracting is the concept of shared risk and reward.

The relationship contracting delivery methods include:

- (a) alliancing;
- (b) EPC and EPCM contracts;
- (c) cost plus contracts; and
- (d) BOO and BOOT projects.

2.4 What are the special features of alliancing?

The key elements of alliancing which differs from the “traditional” contracting methods are:

- (a) the inclusion in the alliance of all members responsible for delivering the project, including the project owner, the contractor and relevant consultants;
- (b) commonly aligned objectives which are usually developed through a mission statement;
- (c) joint and several liability between participants;
- (d) fair and equitable sharing of risk between the participants design to avoid any “win-lose” outcomes;
- (e) a performance or incentive basis of remuneration which includes the payment of costs and an agreed division of profit taking into account performance levels measured against clearly defined key performance indicators (KPIs);
- (f) an integrated project team, formed by the formal alignment of management structure of the alliance participants’ project delivery teams, involving the creation of an Alliance Team (for day to day management) and an Alliance Board (for supervisory tasks, decision on project direction and resolution of disputes at an early stage);
- (g) an environment which encourages innovation;

- (h) unanimous agreement between the alliance representatives, particularly for the division of responsibilities and the type and quality of works and services required to meet the objectives of the alliance;
- (i) commitment to a “best for project” approach;
- (j) open and honest communications, trust, integrity and respect;
- (k) approaching obligations on a “good faith” basis;
- (l) an emphasis on resolving disputes when they arise and at the lowest possible level and, depending on the type of alliance, a “no blame” and “no dispute” culture; and
- (m) the use of a facilitator to guide the alliance participants and help create an alliance “environment”.

The key advantage of the alliance form of project delivery as opposed to the other relationship-contracting methods is that in alliancing, the focus can remain on the allocation of key project risks. However, this allocation of risk is managed by the participants pursuant to a structure which makes it in the financial interests of both parties to cooperate to complete the project in a mutually beneficial way.

The major disadvantage of alliancing is that some alliance contracts are loosely drafted and do not clearly deal with risk allocation between the parties. Further, if the contractor’s remuneration is not tied to its performance, it can make the management of cost “blow outs” very difficult.

2.5 What are the other forms of relationship contracting?

(a) Engineering Procurement Construction (EPC)

The EPC delivery method involves the project owner engaging a contractor to carry out all aspects of the design, construction and commissioning of the project. This project is often known as a “turnkey” project as the project owner, at the end of the process, is meant to simply “turn the key” to start the asset. The advantages of the EPC delivery method include a single point of responsibility, it allows fast track construction and the project owner can obtain a warranty of fitness for purpose from the contractor.

(b) Engineering Procurement Construction Management (EPCM)

Under the EPCM delivery method, the project owner engages a contractor to carry out the design and to manage the procurement and construction of the project. The project owner enters into direct contracts with suppliers and construction contractors. One of the key advantages of this approach compared with the EPC approach is that the project owner can take a more “hands on” approach and have better control over design development. The EPCM delivery method also allows fast track construction. The disadvantages of this method are that the quality of the project may be compromised because the EPCM contractor’s wish to minimise costs and that there is usually no projected total project cost until the construction has been commenced.

- (c) Build Own Operate (BOO) and Build Own Operate Transfer (BOOT)

BOO and BOOT are methods of project delivery in which the private sector is offered a concession by the public sector to build, own and operate major infrastructure. With the BOO method, the ownership of the infrastructure asset remains with the private sector consortium or special purpose vehicle. With the BOOT method, the ownership of the infrastructure asset is transferred to the public sector project owner at the expiration of the concession agreement.

2.6 When should alliancing be used?

The key drivers for establishing an alliance as the framework for delivery of a project include:

- (a) the ability to efficiently pool together knowledge, skills and resources from across a number of parties with differing skill sets;
- (b) the ability to select the “best team” for delivery of the work and services;
- (c) the alignment of objectives;
- (d) the increased possibility of exceeding required performance levels and obtaining a greater reward; and
- (e) the opportunities for economies of scale and increased profit margins.

An alliance should be considered when a project is technically complex or it is difficult to accurately define the finished ‘product’, such as design not being completed prior to going to tender. An alliance may also be appropriate when there is likely to be a long term relationship as the alliance may allow parties to more effectively deal with inevitable problems that arise over the course of the relationship. The most important factor when considering using an alliance is that both parties are willing and capable of working in a co-operative manner.

An alliance would not be appropriate when the above-mentioned key drivers are absent. When there is doubt as to whether the parties involved will be able to work in the co-operative manner necessary for a successful alliance, an alliance should not be used.

3 Practical ways of minimising litigation risk

The most practical way of minimising litigation risk in relation to alliancing is to have a concise and well-drafted agreement which governs the alliance and accurately reflects the intentions of the parties. The probability of disputes which may delay the project increases dramatically if there is a high degree of uncertainty as to the parties’ obligations under the alliance contract.

The key matters that should be covered in the alliance contract are:

- (a) the obligations of each participant;
- (b) the scope of work to be performed;
- (c) the expected outcomes of the project;
- (d) indemnity and insurance;
- (e) variations
- (f) payment;
- (g) termination;
- (h) KPIs;
- (i) risk/reward;
- (j) dispute resolution.

The risk of litigation can be minimised by including a comprehensive dispute resolution clause. This clause will detail how issues or disputes are to be dealt with by the alliance, which is usually to deal with them at the lowest level possible but also providing a mechanism where issues can be ‘escalated’ to higher levels of management within each alliance participant.

A third practical way to minimise litigation risk is to be aware of each alliance participants’ obligations as detailed in the alliance contracts. Often, misunderstandings or disputes arise when parties are not aware of the existence or extent of certain obligations on them.

4 Understanding pure “no dispute” alliancing

4.1 Types of alliances

There are basically two types of alliancing being “pure” or “project” alliance and “impure” or “strategic” alliances. These alliances are similar in terms of their management structures, remuneration structure and express obligations of the parties to work co-operatively and in good faith.

The alliances differ in terms of risk allocation and obligations. In a “pure” alliance, the parties are collectively responsible for performing the work and generally assume collective ownership of all risks associated with the delivery of the project and the parties agree to resolve issues or disputes within the alliance with no recourse to litigation except in the case of “wilful default”. In “impure” alliances, the non-owner alliance participants (as opposed to all alliance participants) typically retain discrete liability for breach of their obligations under the alliance contract and are specifically obliged to discharge those obligations under the alliance contract. In this way, “impure” alliance retain some of the traditional contracting features. “Impure” alliances are generally used more for projects where the parties are better able to identify and quantify the risks assumed.

4.2 The no dispute clauses

Pure alliance contracts usually contain a clause stating that the parties will attempt to avoid disputes, will resolve any issues or disputes within the alliance and that there will be no recourse to litigation except in the case of “wilful default”. The intention of such a clause is to preclude litigation in the case where an act or omission by a participant does not come within the definition of “wilful default”.

One consequence of this “no dispute” alliancing is that lenders are often reluctant to finance these alliance on a non-recourse basis because of the high degree of uncertainty as to the parties obligations and liabilities under the agreement, given the lack of recourse if other alliance participants fail to perform.

The purpose of the no dispute clauses is to encourage innovation and risk-taking by alliance participants, away from the background threat of legal liability. However, there are a number of quite significant practical ramifications of the inclusion of a no dispute clause. These include:

- (a) no rights in relation to negligence: the project owner will have no remedy against other alliance participants for damage or loss suffered as a result of the negligence of other alliance participants;
- (b) no rights in relation to defective work: the project owner will have no remedy against other alliance participants for damage or loss suffered as a result of other alliance participants’ defective work;
- (c) effect on insurance: it is extremely difficult to obtain insurance for wilful default and most design insurances are structured so that the insurer does not have to pay unless the design consultant is liable, which will only occur in relation to wilful default;
- (d) effect on gainshare: the entitlement of each non-owner alliance participant is linked to the performance of all other alliance participants so all will suffer if one fails to perform but there will be no avenue for claiming against the non performing participant.

The significant ramifications of the no dispute alliancing method has led to a hybrid style of alliancing in which the alliance contract contains a no dispute clause that contains exceptions broader than just “wilful default”.

5 Alliancing and the Trade Practices Act

5.1 The Trade Practices Act

The Trade Practices Act 1974 (Cwlth) and the Fair Trading Acts in each state and territory prohibit certain behaviours by corporations. It is important to note that the courts have repeatedly held that parties cannot agree that the Trade Practices Act does not apply to their project.

Section 52 of the Trade Practices Act states that a corporation must not, in trade or commerce, engage in conduct that is misleading and/or deceptive or is likely to mislead or deceive. Importantly, silence can in certain

circumstances constitute misleading or deceptive conduct. If one alliance participant engages in conduct that is misleading and/or deceptive and another alliance participant relies on those statements to its detriment, then the alliance participant who made the statement will be liable for any loss or damage suffered.

Importantly, intention is not a requirement for a contravention of section 52 of the Trade Practices Act. A party may contravene section 52 even if the party making the representation is innocent and has acted in good faith.

5.2 Implication of the Trade Practices Act for alliancing

An example of the application of section 52 is when one alliance participant, prior to the alliance being agreed upon, represents to the project owner that it has the capability to complete certain aspects of the project however, in fact, it does not have the capability to carry out those aspects of the project. If the project owner relies on those statements of the alliance participant and acts to its detriment, by entering into the contract with the alliance participant, then that alliance participant may be liable for any damages suffered by the project owner in relying on those statements. For example, if the project owner suffered delay or had to engage external consultants to carry out those aspects of the project which the alliance participants said it had the capability to complete, then the alliance participant would be liable for those costs.

Section 51 of the Trade Practices Act enlarges the operation of section 52. Section 51A provides that where a representation is made with respect to any future matter and there are no reasonable grounds for making the representation, then the representation will be taken to be misleading. Crucially, section 51A effectively reverses the onus of proof. This means that a party is deemed to not have had any reasonable grounds for making the representation unless it can produce evidence that it did have reasonable grounds. Usually, it would be the responsibility of the party who has suffered damage to prove that there were no reasonable grounds for making a representation but section 51A requires the party against who a claim is made to show that they did have reasonable grounds.

An example of the application of section 51A would be where an alliance participant has stated that it will ensure that the project is finished by a particular date irrespective of whatever may happen during the project. This would be a representation as to a future matter because the statement is about a project finishing on time which is something that will happen at a date in the future. If the project is not in fact finished on time and the project owner suffers loss or damage as a result of the project not being completed by the promised date, then the alliance participant who made the representation would be required to prove that it did have reasonable grounds for making the representation. If the alliance participant cannot show that it had reasonable grounds for making the representation then the representation will be deemed to have been misleading and the alliance participant will be liable for any loss or damage suffered by the other parties as a result of that representation.

One of the key issues for project owners or those parties seeking to make a claim under the Trade Practices Act is the issue of reliance. In large projects, project owners or alliance participants will often have independent advisers, such as consulting design engineers or cost management consultants, who

provide advice as to various aspects of the project. For example, a potential alliance participant makes certain representations to the project owner about their capability to carry out certain aspects of a project during pre-contractual negotiations and gives a document to the project owner which states this capability. The project owner gives that statement to an independent adviser who reviews the document and advises the project owner that they do not believe that the alliance participant has the capability to carry out certain aspects. The project owner receives this advice but chooses to continue with that potential alliance participant because of other economic reasons and then there is a problem with the project because the alliance participant did not in fact have the stated capability. In these circumstances, it would be difficult for the project owner to show that it actually relied on the alliance participants' representations as to capability because it received independent advice on the issue and was aware that the alliance participant may not have had the capability.

Given the extensive application of the Trade Practices Act and the potential significant consequences of a contravention of this Act, parties must be careful, both prior to an alliance contract being signed and during the life of the project, in relation to any statements made to other parties, particularly in relation to future matters.