ENSURING YOUR ALLIANCE CONTRACT IS LEGALLY SOUND[1]

Owen Hayford

Senior Associate, Clayton Utz, Sydney

INTRODUCTION

Alliance contracting, as a contracting strategy, has developed as a result of dissatisfaction with traditional contracting strategies and a desire to achieve better than business as usual outcomes.

It is widely recognised that one of the major contributing factors to the adversarial relationships that characterise the construction industry is the traditional lump sum construction contract. The adversarial relationship arises because the lump sum fixed price nature of the traditional construction contract sets the interests of the owner and the contractor in fundamental opposition.

The contractor's interest, having agreed a lump sum price, is to minimise costs, often at the expense of project performance, in order to maximise profit. This is in direct conflict with the owner's interest which, having agreed a lump sum price, is to secure maximum project performance even if this is at the expense of the contractor's profit margin.

In this framework disputes and dissatisfaction are almost inevitable.

This situation has led many participants and commentators within the construction industry to the conclusion that if relationships are to improve, fundamental changes to the traditional contractual relationship between owners and contractors are required. It is out of this desire to get away from the inherently adversarial nature of traditional construction contracts that relationship contracting and, in particular, alliance contracting, has evolved.

FEATURES OF ALLIANCE CONTRACTS

Core features of 'pure' alliance contracts

There are essentially three features of the pure alliance contract which differentiate it from traditional contracting strategies:

- The first, and most fundamental, is the remuneration regime. Alliance contracts fundamentally altering the remuneration arrangements and risk allocation found in traditional construction contracts, by replacing the lump sum price with a radical new performance based remuneration regime which seeks to closely align the commercial interests of the parties.
- The second core feature is the *no blame, no disputes* clause, under which each party agrees that it will have no right to bring any legal claims against any of the other participants in the alliance, except in the very limited circumstance of a wilful or deliberate default by another alliance participant.
- The third core feature is the requirement for most, if not all, decisions regarding the project to be made by way of *unanimous agreement* between the owner and all of the other alliance participants.

The term 'pure alliance' has been used in describing the core features of the alliance model as alliance contracts now take may forms, some of which may not fully embrace all of the core features of the pure alliance model.

For example, there are many alliances which do not fully embrace the no blame, no disputes concept, or which allow decisions to be made other than

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by way of unanimous agreement, for reasons which are discussed below.

It is important to recognise, however, that these impure or hybrid alliances as they are sometimes called, whilst different to and departing from the pure alliance model, are no less valid than a pure alliance model. They simply reflect the fact that there is no one size fits all when it comes to contracting strategies.

What is important is that the parties understand the nature and, indeed, the limitations of the particular contracting model that they are adopting. For instance, if an owner wishes to adopt a hybrid alliance model under which the contractor assumes sole responsibility for particular risks and is held legally accountable for its work, the owner should not expect the same level of innovation and resultant cost savings, which might be achievable, under a pure alliance model, where the non-alliance participants are free to pursue innovative ideas without fear of being sued if things go wrong.

Radical new approach to remuneration and risk allocation

Remuneration is a fundamental part of any contract, so it is paradoxical that it receives very little attention in most discussions on alliancing contracting.

The project alliance model discards the traditional lump sum price method of remunerating the contractor in favour of a radical new performance based remuneration regime.

Under the typical project alliance model, the contractor's remuneration essentially comprises two discrete components. First, the owner agrees to pay all of the costs incurred by the contractor - and the other alliance participants if there are more than one - on the project, even if they are greater than expected and even if the project fails to perform as expected. These direct costs exclude any profit or margin.

Secondly, the owner typically agrees to pay what is known as a gainshare or fee payment to the contractor, provided certain agreed key performance indicators (KPls) are met. The maximum possible amount of the gainshare payment is a fixed lump sum, rather than a percentage of the final payment cost, agreed upfront. It is generally set at a level which would cover the profit margin and contribution to overheads which the contractor would normally expect to derive under a traditional lump sum contract. Where there is more than one other alliance participant, the gainshare payment is generally shared between the other alliance participants in accordance with pre-agreed percentages - normally based on the share of the work expected to be performed by each.

The KPIs against which the contractor's performance will be assessed are also agreed upfront. At their simplest, they will include a target cost and time for completion. Other KPIs may also be included, depending on the owner's other objectives in relation to the project. Additional KPIs which have been included in Australian project alliances to date include safety, environment, industrial relations, community relations, local industry participation and even the operating performance of the project.

If all the KPIs are achieved, the owner must make the full gainshare payment. However, if one or more of the KPIs is not satisfied, the gainshare payment, and hence the profit derived by the other alliance participants, is reduced. In this way, the non-owner participants put their profit at risk, dependent upon their performance against the KPIs.

Sometimes, the owner will also agree to share any cost savings - that is, the difference betweenthe final cost of the project and the agreed target cost - with the other alliance participants by adding a proportion (say 50%), of the cost savings to the total gainshare payment available for distribution to the other alliance participants if the other KPIs are met. In this way, extraordinary performance can be rewarded with extraordinary profits.

The dynamics of the remuneration regime

The separation of the payments on account of:

- the contractor's direct costs; and
- its profit and corporate overheads

is designed to overcome some of the problems associated with more traditional remuneration structures and to achieve a much closer alignment of the commercial interests of the owner and the other alliance participants.

For example, where a contractor is required to commit to performing a task for a fixed lump sum amount, the contractor will almost always include within the fixed lump sum amount an additional amount to cover the possibility that it may cost the contractor more than expected to complete the task. These additional amounts, or contingencies, will typically include a proportion of the additional costs which the contractor would expect to incur if risks for which it is responsible materialise, together with an amount to cover any remaining uncertainty associated with the scope and cost of the work.

The problem with these contingencies is that:

- they often cover a number of different risks which the contractor is required to bear, some or all of which may not ultimately materialise; and
- the owner is required to pay them regardless of whether or not the risks materialise.

By agreeing to pay all of the actual direct costs of the other alliance participants, even if they exceed the agreed target cost, the need for the owner to pay such contingencies is eliminated. This results in cost savings for the owner if the risks which such contingencies were designed to cover do not materialise. The flip-side, of course, is that the risk of cost blow-outs is predominately borne by the owner. The exposure of the other alliance participants is generally) limited to loss of their gainshare payment (ie, their profit margin and contribution to corporate overheads). To this end, the agreed target cost should exclude any such contingencies.

The way in which the remuneration arrangements in a typical project alliance more closely align the commercial interests of the owner and the other alliance participants, and thereby encourage the desired behaviour, can also be seen by contrasting the project alliance remuneration regime with a more traditional cost plus remuneration structure.

Under a cost plus arrangement, the contractor is generally paid its costs plus a margin which

> ... the remuneration arrangements in a typical project alliance more closely align the commercial interests of the owner and the other alliance participants ...

is calculated as a percentage of those costs. The problem with this form of remuneration structure is that it causes the interests of the contractor to depart from those of the owner - as the costs of the project increase, so to does the contractor's profit margin. The contractor should be encouraged to reduce project costs, not increase them.

The project alliance remuneration structure outlined above avoids this divergence of interests by:

- excluding from the direct costs which the other alliance participants are entitled to be reimbursed any profit or margin component; and
- making the gainshare or fee payment a fixed lump sum amount, rather than a percentage of the final project cost

By structuring the remuneration arrangements in this manner, the incentive which would exist in a more traditional cost plus arrangement for the other alliance participants to increase the project cost in order to increase their profit margin is removed.

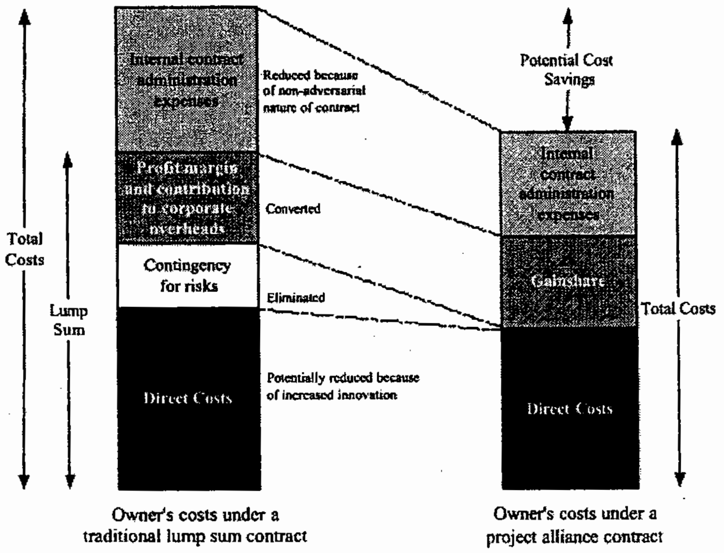
Sharing of risks

At first sight the requirement for the owner to pay all the costs incurred by the other alliance participants, regardless of whether the project comes in over or under the agreed target cost, might seem to suggest the owner solely bears the risk of increased or unforeseen costs.However, the risk is in fact shared between the owner and the other alliance participants as any increased or unforeseen costs will cause the final project cost to exceed the target cost (assuming the agreed target cost doesn't include contingencies), thereby reducing the gainshare payment, and hence the profit, derived by the other alliance participants.

Potential cost savings for owners

Even though the remuneration arrangements in a project alliance will generallyprovide the non-owner alliance participants with the opportunity to derive extraordinary profit margins in addition to the recovery of their direct costs, the remuneration arrangements should also result in cost savings for the owner.

The potential cost savings for owners are shown in the diagram below.


Total Costs
Lump Sum
Internal contract administration expenses
Reduced because of non-adversarial nature of contract
Profit margin and contribution to corporate overheads
Converted
Contingency for risks
Eliminated
Direct Costs
Potentially reduced because of increased innovation
Potential Cost Savings
Internal contract administration expenses
Gainshare
Total Costs
Direct Costs

Owner's costs under a traditional lump sum contract

Owner's costs under a project alliance contract

As shown in the left-hand column, under a traditional lump sum contract the price has three components:

- an amount the contractor charges to cover the direct costs it expects to incur in completing the work;
- an additional amount, or contingency, to cover the additional costs which the contractor will incur if risks for which it is responsible under the traditional contract (such as bad weather or latent site conditions) materialise; and
- the contractor's profit margin and contribution to overheads.

In addition, the owner also has to meet its own internal contract administration expenses, in checking the contractor's work, processing payment claims and managing and defending any disputes.

Under a project alliance contract, as shown in the right-hand column:

- there is a potential for, but no guarantee of: a reduction in the direct costs, due to the no blame, no disputes clause. This clause is discussed in more detail in the section below, but essentially the no blame, no dispute clause allows the participants to innovate and take risks in the pursuit of cost savings and enhanced project performance without fear of legal claims if they fail. This no blame culture should result in increased innovation and resultant cost savings which would simply not be achievable in a traditional adversarial contracting environment;
- the contingency cost is eliminated, because the owner has already committed to pay all the costs incurred by the contractor even if they exceed the target cost;
- the contractor's normal profit margin and contribution to overheads are converted to the gainshare payment. As previously mentioned, the maximum possible gainshare payment is agreed upfront, and is set at a level which would cover the profit margin and contribution to overheads which the contractor would normally expect to derive under a traditional lump sum contract. Any additional gainshare payments on account of extraordinary performance are generally only paid if the final project cost is less than the agreed target cost, and are typically wholly funded from such cost savings; and
- the owner's internal contract establishment and administration expenses are often reduced, because the non-adversarial nature of the relationship reduces the resources required for managing and defending claims and disputes. Whether an alliance contract will always result in lower internal contract establishment and administration expenses is, however, debatable given an alliance contract will often involve higher tender and contract establishment expenses and more senior management time during the contract administration phase.

There is thus a significant potential for overall cost savings to the owner.

No guarantee of a lower project cost

Although there is significant potential for the owner to derive cost savings, there is no guarantee that the adoption of a project alliance will result in the delivery of the project at a lower cost than would have been achievable under a traditional lump sum contract. Indeed, given the owner is obliged to pay all of the direct costs incurred by the other participants, even if costs exceed the target cost of the project, the owner's cost exposure is potentially unlimited (subject to its right to terminate the contract). It is for this reason that the adoption of a project alliance by the owner can be said to require 'leap of faith' on the part of the owner that the potential efficiencies available under a project alliance structure will be realised and result in a lower project cost.

Owner pays for contractor's mistakes

Compounding the above issue is the fact that under a project alliance, the owner is obliged to pay the costs incurred by the alliance participants in redoing work which participants failed to do properly the first time. Whilst such additional costs will be at the expense of the contractor's profit/gainshare entitlement, the contractor's costs are guaranteed. It is this feature of the pure alliance model in particular which some owners have found to be a difficult pill to swallow and which has caused them to explore the variations to the pure project alliance model discussed below.

No blame, no disputes - but consider the ramifications

Under the no blame, no disputes clause found in the pure alliance model, each alliance participant agrees that it will have no legal claims against any of the other alliance participants, except in the case of narrowly defined *wilful default*.

The purpose of this clause is to encourage the alliance participants to come out of their comfort zone, to take risks, and to accept stretch targets in the pursuit of extraordinary results, without fear of legal claims if they fail.

However, the ramifications when things go wrong can be far reaching.

For example, because the entitlement of each non-owner alliance participant to its gainshare payment depends on the performance of the other alliance participants, if anyone of them fails to perform adequately then all of them will suffer - but none of them will have any claims against the non performing participant.

Further, the inclusion of this clause also means that the owner will have no remedy against the other alliance participants for losses suffered by it as a result of the negligence, or inefficient or defective work practices, of the other alliance participants.

Whilst the no blame, no disputes clause applies to both the owner and the other alliance participants it generally involves a greater concession on the part of the owner given it is the non-owner participants that carry out the work, with the owner's main obligation being that of payment (a breach of which is usually defined to constitute a wilful default).

The no blame, no disputes clause can also give rise to problems in relation to design insurance. This is because most insurances available to designers are liability based insurances, which means that the insurer won't pay unless the designer is *liable*. Under a no blame, no dispute clause the designer (like all participants) will only be liable for wilful default, which most design insurances specifically refuse to cover. Accordingly, if the owner is to have any comfort in this area, it will require some tailored form of insurance. Unfortunately for owners, insurers are generally reluctant to assume risk where the person who will primarily carry out the task does not carry any personal responsibility.

Given these ramifications, some owners have adopted alliance structures without the no blame, no disputes clause, or clauses with a broader exception than just wilful default.

Some will argue that the no blame, no disputes concept is an essential ingredient of the project alliancing approach. Certainly, if the owner wants to achieve a high level innovation from the other alliance participants which involves risk taking, then the inclusion of a no blame, no disputes clause will assist in achieving this objective. However, there doesn't seem to be any reason why some of the benefits of the pure alliance model, such as the partial[2] elimination of risk contingencies included in lump sum price under a traditional construction contract and the ability of carefully structured KPIs to align commercial interests and drive desired behaviour, cannot be obtained at least in part, without such a clause.

Issue resolution and the requirement for unanimity

Another unique feature of the pure alliance model is the establishment joint decision making bodies, such as an alliance board comprising representatives of the owner and each other alliance participants, and the requirement that all decisions be made by these bodies by unanimous agreement.

The *alliance board* is analogous to a board of directors and fulfils a high level management and decision making function. Important decisions concerning the alliance, such as whether adjustments should be made to the remuneration regime following a major change to the scope of the works, are referred to the alliance board for resolution. The alliance board is also required to consider and resolve any differences of opinion which can't be resolved within the integrated project team.

Whilst the establishment of such a body is not unique to project alliances, the requirement for all decisions of the alliance board to be made by unanimous agreement is. The requirement for unanimity means each participant has a right of veto, and if unanimous agreement can't be reached, no decision is made. The pure alliance model does not include a deadlock breaking mechanism to resolve any deadlocks which arise at the alliance board level.

This arrangement is considered by many that have worked within an alliance structure to be crucial to the success of the alliance approach. They argue that the need to achieve Unanimity to proceed (and the absence of a deadlock breaking mechanism) forces the parties towards mutually acceptable solutions. The requirement for unanimity coupled with the no blame, no disputes clause takes away the options of 'I'll do it your way, but I'll claim it' or, 'You'll do it my way, and if you don't like it claim it'.

But what if unanimity simply can't be achieved? An inability to resolve a dispute which cannot be resolved within the alliance can bring uncertainty to the ongoing legal basis of the alliance. A court will not enforce an agreement to agree. Accordingly, if an alliance contract is dependent upon the alliance board reaching unanimous agreement in relation to a matter which needs to be resolved in order for the alliance to continue, then the parties run the real risk that the agreement will be legally unenforceable in the event unanimity can't be achieved.

That said, some may take the view that the legal enforceability of a pure alliance agreement is of limited value in any event, and that more damage than good may be done by seeking to make it legally enforceable.

The absence of an ability to quickly resolve deadlocks at the alliance board level can also result in significant delays to the progress of the project, although this will have commercial ramifications for the non-owner alliance participants where time of completion is a KPI.

Some owners have also made the observation that the requirement for unanimity has resulted in a loss of ownership and control over the project, although may be a case of wanting 'to have the cake, and eat it too'.

It is for these reasons that some alliance contracts incorporate variations to the pure alliance model involving:

- in some cases, the ability to resort to an alternative dispute resolution process outside the alliance to resolve those disputes which can't be resolved within the alliance; and
- in other cases, the owner having a casting vote in relation to certain types of decisions, but on the basis that the 'knock.on' effect of the decision on, say, the remuneration regime will be determined by the normal decision making process.

One of the alternative dispute resolution process some alliances have adopted is the so called 'swing-man' dispute resolution process. Under this process, disputes which can't be resolved unanimously by the alliance board are referred to an independent third party, and each alliance participant submits to the third party its position as to how the dispute should be resolved.

The independent third party must then choose which of the competing positions it prefers, having regard to the terms of the alliance agreement. The independent third party is only entitled to choose between the competing positions submitted to it by the alliance participants, and is not entitled to impose its own solution on the parties. The position chosen by the third party is treated as final and binding on the participants.

The theory behind this form of dispute resolution process is that the parties will be discouraged from putting extreme positions to the independent third party, for fear that the third party will prefer the position of the other party, and that this will assist in achieving a resolution which all participants can live with, minimising any ongoing damage to the alliance relationship.

2.5 Scope changes

Generally the owner has the right to vary the scope of the works under a project alliance, without impacting on the remuneration regime or the KPIs, It is only if the alliance board unanimously considers that there has been a *major change* to the scope of the works that the remuneration regime and, in particular, the target cost and time for completion KPIs are modified. Typically, all modifications to the remuneration regime are to be determined by unanimous decision of the alliance board.

Termination

The pure project alliance model usually gives the owner the right to terminate the agreementfor convenience (that is, without cause), subject to the owner

The theory behind this form of dispute resolution process is that the parties will be discouraged from putting extreme positions to the independent third party ...

reimbursing the other alliance participants for all direct costs incurred by them prior to and as a consequence of the termination, together with a portion of the gainshare payment based on the proportion of the works completed at the time of termination.

Also, if a non-owner alliance participant commits a wilful default or becomes insolvent, then the remaining alliance participants acting together will typically have the ability to suspend any further payments to the defaulting participant until the default is remedied and/or to exclude the defaulting alliance participant from any further participation in the alliance andengage a third party to replace the defaulting participant.

This right of exclusion for wilful default or insolvency is considered important given non-performance by anyone alliance participant will affect the gainshare payment, and hence the rewards, available to others.

Consistent with the 'no blame, no disputes' concept found in pure alliances, the owner does not usually have the right to exclude an alliance participant from further participation for a breachwhich does not constitute a wilful default. However, as mentioned above, some owners are adopting alliance structures which do not incorporate the standard 'no blame no disputes' concept. In these cases, owners may also consider a right to terminate for serious breaches falling short of a wilful default to be appropriate, with the defaulting participant forfeiting its entitlement to any gainshare payment.

Selection process based on 'non-price' criteria

The selection process which an owner will adopt for a project alliance is quite different from that used for a tradition construction contract. In particular, owners typically select the other alliance participants based on *non-price criteria*, such as expertise, safety record, current commitments and ability to work within an alliance framework. Price is often not considered until well into the selection process, after the other alliance participants have been shortlisted and the parties are collaboratively setting the project's target cost and the other KPIs.

Probity issues for government agencies

The selection process associated with project alliances creates a challenge for owners that are government agencies, given the requirement that government must demonstrate probity in respect of the selection process, and the establishment of the target cost and other KPIs against which performance and entitlements to gainshare payments will be assessed. It is more difficult to demonstrate value for money, fair dealing and accountability where the tender criteria are 'soft dollar' criteria, and where the target cost and other KPIs are established collaboratively with the alliance participants.

In order to satisfy the probity requirement, the government agency will implement a rigorous program of independent auditing of the bidding process, the terms of the alliance agreement and the assessment of performance. The probity of the target cost is usually established in ways:

- by independent verification of the 'business as usual' estimates provided by participants against industry norms; and

- by assessing the target cost against a probabilities analysis of the tender prices which the government would have received had it called for tenders based on conventional lump sum contract.

Some owners have also sought to address the value for money concern by:

- deferring the selection of the successful participants until after target costs have been developed and bid by the competing teams; and

- factoring the target costs bid by each team into the evaluation process.

There is, however, some debate within the industry as to the potential downsides of this approach and whether it has the potential to undermine the very foundation of a successful alliance.

Fiduciary obligations and duties of good faith

There is still considerable uncertainty as to the legal and contractual effect of giving the sorts of relationship contracting commitments typically found in a project alliance agreement agreement or, for that matter, a partnering charter. Committing to concepts such as honesty, trust and sharing may fundamentally alter the parties' legal obligations. Particular care is required in the areas of good faith and fiduciary relations.

It has been suggested by several commentators that the inclusion of such commitments can result in contractual rights being qualified by obligations to act reasonably or in *good faith*.

Moreover, it has also been suggested that project alliances may inadvertently impose fiduciary obligations on the alliance participants because alliance relationships rely upon each participant acting in the interests of the others. A fiduciary relationship arises when one person is able to take advantage of another, who places trust, reliance and confidence in him or her by reason of his or her experience, position or influence. If such relationship is held to exist, then the law will impose certain additional obligations on the alliance participants.

There is authority in Australia for the proposition that parties to a joint venture agreement put themselves in a position where fiduciary obligations are imposed. Fiduciary relationship may certainly arise, for instance, in a partnership.

If the concept of fiduciary obligations is applicable to project alliances[3], then the obligations of the alliance participants will be significantly more onerous. In particular, participants would be obliged to, amongst other things, disclose all relevant facts and circumstances, act with utmost good faith, and not permit their own interests to conflict, or potentially conflict, with those of the other participants. Participants would also be precluded from using knowledge or opportunities obtained as a result of their participation in the alliance for the advantage of themselves or a third party, or to the disadvantage of the other participants.

Unfortunately, the law in Australia relating to good faith and fiduciary obligations is far from settled in the context of

Particular care is required in the areas of good faith and fiduciary relations.

relationship contracting, and project alliances in particular. To avoid uncertainty in these areas, the best policy is to consider these issues and specifically address them when drafting the project alliance agreement.

Added potential for legal relationship to be affected

The creation of joint management panels such as the alliance board provide valuable opportunities for communication and joint problem solving. However, they also provide a forum in which statements can be made by one party which might affect its legal rights. For example, one party might say during a meeting of the alliance board that it won't insist on strict compliance with the contract. If the other party acts in reliance upon this statement the first party may be prevented from subsequently asserting its rights under the contract as a result the operation of the doctrine of promissory estoppel. Alternatively, the first mentioned party may be taken to have 'waived' its right to insist upon strict compliance with the contract.

Similarly, the parties may during such meetings reach an oral agreement which has the effect of amending their written contract, even if the contract contains a clause requiring all amendments to be in writing signed by both parties.

Whilst these issues can arise in relation to any sort of contractual relationship (including conventional lump sum construction contracts), the dynamics of a project alliance relations with its regular meetings increases the likelihood of such events occurring.

Parties contemplating an alliance relationship need to be aware of these legal risks.

CONCLUSION

Alliance contracts now come in many shapes and sizes as alliance participants and, in particular, owners have sought to adapt the pure alliance model to better suit their particular requirements and objectives. There is no 'one size fits all' when it comes to contracting strategies, including alliance contracts. The model which will best suit a particular project will depend upon the nature of the project and the particular objectives and requirements of the owner and the other alliance participants. Each project and contract needs to be considered on its merits.

What is most important is that the parties clearly understand the nature of the relationship that is proposed, and the risks and opportunities associated with it, so that the appropriate strategies can be put in place to maximise the opportunities and manage the risks. Parties should also appreciate that whilst it is possible to 'tone down' the pure alliance model in an effort to address some of the more controversial features of that model, doing so can have the effect negativing some of the advantages and opportunities which the pure project alliance model designed to provide.

REFERENCES

[1] Some sections of this paper are based on papers previously prepared by Doug Jones AM, Partner, Clayton Utz.

[2] If the non-owner participants are to be held responsible for their work then they are likely to incorporate a contingency for this risk within the lump sum gainshare amount.

[3] It may not be the case: it may be that participants do not undertake to act in ech other's interests so much as attempt to align their interests with those of other participants.

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