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Risk exposure of designers and constructors under alliance contracts

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Key Points:
Designers and constructors participating in alliances may be exposed to a wider range of risks than is commonly understood.

Alliance contracting in Australia developed as a result of dissatisfaction with the adversarial nature of traditional contracting strategies and a desire to achieve better than "business as usual" outcomes. They have become increasingly popular as a consequence of the stronger bargaining position of contractors in the current fraught construction market. The aim of alliance contracts is to align the interests of all the parties involved in a project in order to avoid disputes and encourage innovation.

In order to achieve these ends, alliance contracts depart substantially from "traditional" fixed-price, lump-sum construction contracts. As a result, in setting the terms of and administering alliance contracts, participants must advert to a number of issues that do not arise (or only arise quite differently) under that more established contractual form.

Although some attention has been given to these unique concerns arising out of alliance contracts, particularly from the perspective of owners, issues that assume distinct significance for non-owner participants ("NOPs"), a category which includes not only the head construction contractor, but also other parties such as designers and technology providers, are not always well understood. In particular, it is often the case that insufficient consideration is given to the scope of the liabilities that NOPs may face, and the extent to which these may vary between different alliance contracts.

Pure vs hybrid alliances

The first thing that any potential participant in a alliance should be aware of is that alliance contracts can take many forms. Although there is no one standard alliance contract in Australia, there are several forms which have been used (with minor variations) on a number of projects.

Project alliance contracts are typically described as being either pure alliance contracts or hybrids. A pure alliance contract is one which incorporates all three of the following core features:

- a "no blame, no disputes" clause, under which each participant agrees that it will have no right to bring any legal claims against any of the other participants (except in very limited cases of default);
- a remuneration regime that replaces the traditional lump-sum price with a performance-based approach that seeks to closely align the interests of the owner and the NOPs by providing for payment of NOPs for their services under a three-limb compensation model comprising:
  - Limb 1: the reimbursement of the NOP's project costs on a 100 percent open book basis;
  - Limb 2: a fee to cover normal profit and (non-project specific) corporate overheads; and
  - Limb 3: a gainshare/painshare regime where the rewards of outstanding performance and the pain of poor performance are shared equitably among all alliance participants; and
- a requirement for unanimous agreement between all alliances participants on all key project issues.

Hybrid alliances, on the other hand, are alliances which do not fully embrace all of the above core features of a pure alliance. For example, there are many alliances which do not fully embrace the "no blame, no disputes" concept (eg. by seeking to make NOPs solely responsible for their own defective work), or which allow certain decisions to be made other than by way of unanimous agreement.

Accordingly, NOPs need to consider the terms of each alliance contract, in order to assess their potential liabilities and risk exposure under that contract. It is dangerous to assume that the risk exposure of a NOP will be similar under every document described as an alliance contract. In our experience, it can differ significantly from one project to another.

Potential liabilities of NOPs under an alliance

It is sometimes suggested that the liability of a NOP under an alliance contract is limited to loss of its "Limb 2 Fee", as described above.

While this is broadly correct as regards the liability of a NOP to the owner and the other NOPs for negligent or defective work performed by the NOP, there are a number circumstances in which the liability of a NOP can exceed the loss of its Limb 2 Fee. These are discussed below.

Wilful default and insolvency

As mentioned above, pure alliance contracts will typically state that no alliance participant will have any legal liability to any other

alliance participant except in the case of "wilful default" or an event of insolvency. Wilful default is typically defined to include:

- deliberate or reckless conduct which the participant knew or ought to have known would cause harm to another participant;
- failure to honour an indemnity;
- failure to make a payment that has fallen due under the agreement;
- material failure to effect required insurances;
- intentional failure to honour "open book" audit obligations;
- intentional breach of obligations in respect of third party intellectual property rights; and
- fraudulent conduct.

Accordingly, the liability of a NOP for losses incurred by other alliance participants as a consequence of a "wilful default" by a NOP, or the insolvency of a NOP, is not limited to loss of the NOP's Limb 2 Fee. Rather, the liability of the NOP for such losses is unlimited.

Liability to third parties

An alliance contract will only bind the parties to it. While the contract can largely regulate the liability of the alliance participants to each other (including liabilities for third party claims), it cannot affect any rights which third parties might have to bring a claim against one or more alliance participants arising out of the conduct of an alliance participant.

The question then arises as to how the liability of an alliance participant to a third party which arises in connection with the project is to be shared as between the alliance participants to the extent such liability is not covered by insurance.

This, of course, will depend on how the alliance contract addresses this issue. In many cases, the premiums and excesses payable by the NOPs are treated as reimbursable costs. Uninsured liabilities to third parties are also typically (but not always) treated as reimbursable costs, except where such liabilities arise as a consequence of wilful default.

NOPs should take care to ensure that this issue is adequately addressed in the alliance contract. Often, it is not.

Liabilities which cannot be excluded at law

There are some matters for which it is not legally possible to exclude or limit liability under Australia law. A good example of this is liability which an alliance participant might incur to another alliance participant or a third party under section 52 of the *Trade Practices Act* 1974 (Cth). Section 52 prohibits corporations from engaging in misleading or deceptive conduct. Equivalent State and Territory legislation also prohibits individuals from engaging in such conduct. Persons who suffer loss as a result of a contravention of section 52 can recover such loss under the Act. Liability for a contravention of section 52 is strict (ie. it does not matter whether the party intended to mislead or deceive), and cannot be excluded or limited by contract.

Accordingly, a NOP is not able to limit its liability to another alliance participant or a third party for losses arising from misleading or deceptive conduct by that NOP. Nor could a NOP enforce a promise by another NOP or the owner to waive any rights it might have to commence proceedings arising out of a contravention of section 52.

Other examples of liabilities which cannot be excluded or limited at law include:

- liability for fines or penalties (eg. under environmental protection legislation); and
- liabilities under statutory implied warranties in relation to the sale of goods.

Conclusion

Designers and constructors participating in alliances may be exposed to a wider range of risks than is commonly understood. In particular, they may face liabilities (both to third parties and the other alliance participants) that are not limited to the pre-agreed amount providing for "normal" profits and general corporate overheads. It is therefore important for all non-owner parties to alliance contracts, and their advisers, to:

- consider how the contract addresses those liabilities that can be determined between the parties; and
- be aware of those liabilities that cannot be limited or excluded under the contract or otherwise.

For further information, please contact Owen Hayford.

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