CONTRACTING IN THE THIRD MILLENNIUM —RELATIONSHIP CONTRACTING PART 2

Marko Misko
Partner
Clayton Utz

Part 2 of Marko Misko's article continues from issue #79 of *ACLN*. Unfortunately, due to a production error, the full text was not included in our last issue.

3.7. Alignment of Interest —Incentivisation

(a) Alliancing

The remuneration strategy under an alliance is absolutely critical. It must align the interests of the parties and shape their conduct, so that they have a common objective in delivering the project in accordance with the required cost, time and quality parameters. This is particularly critical given the acknowledged absence of legal remedies (other than for wilful default).

Typically, alliance participants will be paid for the direct cost of their efforts on a reimbursable basis. Although this may come as a surprise to some, this will include the cost of rework to address defective design or work, even if the relevant participant was responsible for the defect.

The participants will then typically be paid their margin by sharing in a 'profit pool' in agreed proportions. The parties have a strong common objective in delivering the project in accordance with the required cost, time and quality parameters, as the size of the 'profit pool' and therefore their respective margins will fluctuate depending on the collective alliance performance against KPIs.

(b) Managing Contractor

The remuneration strategy under managing contractor is also critical to its success.

Under managing contractor, the primary interest of the principal is in achieving the best possible solution within the target cost. To do so, the nature of the project will usually require the contractor to explore alternative designs and contract delivery methods.

Conversely, the primary interest of the contractor is to earn its tendered profit.

Accordingly, to align the parties' interests, managing contractor removes the tension inherent in lump sum delivery. The managing contractor is required to tender a management fee (which effectively represents its margin for managing project delivery) based on a target cost and the original scope of work. That fee remains fixed regardless of the actual scope of work, subject only to a fundamental variation in the workscope outside certain limits. However, the managing contractor is reimbursed the actual costs of consultancy services together with a percentage margin on those costs, which essentially means that the contractor earns more (rather than less) if it carries out more design. The intention is that this not discourage the contractor from exploring all reasonably viable alternative design for the project.

Further incentive is provided in relation to the time requirements of the managing contractor. Although the contractor has only has to use its best endeavours to achieve the target date, because the contractor has a fixed management fee (and therefore a fixed level of profit to be earned), it is clearly in the contractor's interest to achieve completion sooner rather than later. This also applies to the contractor's 'preliminaries fee', which covers all other work performed by the contractor such as providing common site facilities etc.

(c) Collaborative Contracting

As with managing contractor, under a collaborative contracting model it is critical to ensure that the contract provides a sufficient alignment of interests and effort. The two primary ways of achieving this are to:

- firstly, ensure that the risk allocation provides for a meaningful sharing of risk as between the principal and the contractor; and
- secondly, provide some form of incentivisation if the contractor

achieves in excess of the minimum benchmarks.

The collaborative contracting approach under the Defence Comprehensive Maintenance Contracts (CMC) is an excellent case study of a risk allocation and remuneration strategy directed towards aligning the key interests of the parties. It is beyond the scope of this paper to discuss these detailed mechanisms. However, a detailed analysis of those matters is available in other papers I have delivered and I would be happy to provide details of these if required.

(d) Partnering

There has never been any doubt that partnering deals with the 'soft' issues very well. It does so, through partnering workshops and partnering charters promoting a joining of *efforts*.

However, a joining of *interests* is not the same as a joining of *efforts*. Partnering has the tendency to do the latter without doing the former. Conversely, alliancing and other relationship contracting models require the parties to agree to join efforts and then aligns their interests (to a greater or lesser extent) so that they have a real incentive to do so.

The upshot is that partnering can run into difficulties where there are insufficient joint interests to fuel joint efforts. This is exacerbated by the fact that partnering mechanisms are typically grafted onto existing standard forms of contracts without any consideration of the appropriateness of the risk allocation under those contracts.

3.8. Allocation of Risk and 'No Blame' Culture

(a) Alliance

A 'no blame' culture is the crux of the alliancing delivery structure. Essentially, it provides that the alliance participants have no liability to each other for failure to perform their obligations under the alliance agreement other than in the case of 'wilful default'. That term is usually narrowly defined to mean only such wanton and reckless acts or omissions which amount to a wilful or utter disregard for their harmful and avoidable consequences, but does not include errors of judgement, mistakes, acts or omissions, whether negligently or not, made in good faith by alliance participants.

The proponents of alliancing argue that such a release of liability is required to create a true 'no blame' culture. In turn, such a culture is necessary to ensure that the participants focus on breaking through and resolving issues as they arise, rather than on pointing the finger and witch hunts.

Clearly, this can be a contentious issue for parties which require accountability for contractual performance, such as in the public sector or in the context of project finance on a limited recourse basis. The primarily implications are two-fold:

- accordingly to logic which may seem perverse to some, the principal pays for the cost of rework, subject to the contractor being exposed to the possibility of having its margin reduced (because of reduced performance against KPIs);
- in the event of a catastrophic problem (such as a fundamental design defect which prevents, say, a processing plant from successfully achieving commissioning) it may be that the parties are denied access to insurance. For instance, because professional indemnity insurance is premised on fault, where that designer is released by the other participants from liability for its fault, then the professional indemnity insurance is unlikely to respond.

(b) Managing Contractor

The managing contractor model seeks to align the interests of the parties whilst at the same time providing a regime of contractual rights and obligations if things go wrong.

As already discussed, managing contractor aligns the interests of the parties by removing the inherent tension in fixed time/fixed price delivery.

As against this, however, the managing contractor preserves the prime liability of the contractor to the principal for the quality of design and construction. Accordingly, if there are defects in design or construction, then it is a matter for the contractor to carry out rework at its cost.

In a nutshell, rather than seeking to provide a 'no blame' culture, the managing contractor seeks to balance the removal of adversarial tensions where it is consistent with the alignment of the commercial interests of the parties (in respect of time and cost) whilst at the same time preserving the principal's legal remedies in the event of defects in the quality of design or construction.

(c) Collaborative Contracting

Given the criticality of the $13 billion Defence infrastructure maintained under the CMC, the Defence approach to collaborative contracting has been that the contract is an insurance policy. It is therefore drafted for when things go wrong, not for when things go right.

Implicit in this principle is that Defence requires the existence of an enforceable contract, unlike under alliancing, where the alliance agreement may not be a legally enforceable contract.

However, at the same time, Defence has not sought to shunt all risk onto the contractor. Rather, Defence has sought to allocate and share risk meaningfully, in a way which can be enforced in practice, and which aligns interests of the parties.

(d) Partnering

Partnering charters typically include statements requiring the parties to act in good faith and to have regard to the terms of the underlying contract—in the event of an issue arising—as a measure of last resort only. Further, inevitably, the parties will make representations to each other about the way in which they intend to administer the contract, both during the partnering workshop and otherwise in the course of formal/informal interaction.

All in all, these statements and representations contain worthwhile and admirable principles and objectives. However, the difficulty is that they are typically superimposed on a standard form contract with adversarial risk allocation.

4. CRITICAL ANALYSIS —COMMERCE V THE LAW

4.1. Generally

In considering whether to adopt a relationship contracting approach to a project, and the features of the model to be adopted, both clients and their advisers need to be fully-informed of the legal and commercial implications of doing so. They then need to identify and prioritise their legal and commercial objectives for the project and satisfy themselves that such a delivery structure is consistent with those objectives.

Ultimately, because of the challenges in using such contract structures, advisers need to be aware of the risk and play the 'devil's advocate', to ensure their clients make fully-informed decisions (and are not simply seduced by buzz words). Advisers therefore need to be alive to the various forms which relationship contracting has taken (or could take) and think flexibly and practically to arrive at workable solutions.

4.2. Alliancing

There is no question that alliancing can create a project environment in which the alliance participants can achieve exceptional results. However, it needs to be understood that this is a result of careful selection of the participants and the creation of a commercial structure under which it is in all participants' best interests to focus on those results. Unless those factors are present, alliancing of itself will not ensure success.

As against this, from a legal perspective, the downside is obvious: in the event that things go wrong, the principal could be liable for substantial costs of rework and could suffer significant other losses as well. The participants could be deprived of their ordinary legal rights against each other for defective design or construction and therefore (particularly in the case of defective design) they might be deprived of resort to insurance. This may not be acceptable to a party who requires the certainty of outcome provided by a more traditional approach to risk allocation.

Further, an alliance structure is unlikely to be suitable for a minor or simple project or one which has a fixed scope of work. In the former case, a minor project is unlikely to be able to justify the large commitment of resources required for the establishment and management of an alliance structure. In the latter case, a project with little flexibility as to workscope is unlikely to provide the parties with the opportunity to achieve exceptional outcomes.

Ultimately, it would seem that many of the potential advantages which can flow from alliancing can be preserved by combining it with a more 'conventional' risk allocation. For instance, with a few subtle tweaks of the alliance board and 'no blame' provisions, the parties could establish a relationship

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contract which provides them with most of the benefits of alliancing but at the same time retains contractual certainty and meaningfully enforceable rights and obligations. The only drawback—it would seem, according to the alliancing proponents—is that you would not then be entitled to call that structure an 'alliance'.

4.3. Managing Contractor

Managing contractor provides an excellent compromise position for parties seeking a 'softer' risk allocation than is usually provided under traditional contracting delivery methods, whilst at the same time retaining legal certainty and accountability for performance.

It has been noted that the managing contractor (in its bare form) perhaps provides the contractor with insufficient incentivisation to strive for exceptional results. Although adversarial tensions are reduced by the use of a target date and target cost, the other financial incentives are said to be too subtle. For instance, it would be quite simple for the parties (if this accorded with their commercial objectives) to provide the contractor with a bonus for achieving completion before the target date and a share of cost savings for delivery within the target cost. Additionally, further KPIs could be developed (dealing with quality, safety and the like), and payment of the time-related bonus and share of cost savings could be made subject to achieving those.

4.4. Collaborative Contracting

Essentially, collaborative contracting (at least as adopted under the Defence CMC) seeks to blend:

- the alignment of efforts which is the hallmark of partnering, but without the potential legal risks flowing from partnering charters and partnering workshops;
- the alignment of interests and the provision of incentives to the contractor through the underlying contract, which are the hallmark of alliancing; and
- the retention of legal certainty and accountability for performance, which are the hallmark of managing contractor.

As against this, critics of collaborative contracting might say that the 'no blame' culture is not sufficiently entrenched in the CMC. The contractor assumes strict liability for its performance and, in certain contexts, substantial risk.

However, it is freely understood by all parties that Defence is heavily relying on the contractor to deliver high standards and Defence needs to have accountability for performance if things go wrong. The contractor is required to tender a lump sum for assuming risk, but then is given several opportunities under the contract to make this work to its benefit.

Further, there has not been a single formal dispute (even at the first stage of expert determination) since Defence first started contracting out its maintenance in 1994, using a one team approach which was the precursor of collaborative contracting.

4.5. Partnering

The most admirable aspect of partnering is that it brought into focus for the industry the need to focus on 'soft' issues associated with the relationship between the parties.

However, the inherent flaw in partnering *simpliciter* is that it does not go beyond requiring the parties to agree to co-operate and join efforts, by aligning their interests so that they have a real incentive to do so. To that extent, it is well and truly a 'dinosaur'.

Accordingly, any solicitation to enter into a project contract on a 'partnered' basis should be reviewed with a discriminating eye. Although the intentions might be entirely honourable, they should be carefully documented in the underlying project contract and not simply recorded separately through a partnering charter. Once this starts happening, in any event, it starts to become collaborative contracting.