Alliance Contracts - A Partnership In Business

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WHY ARE ALLIANCE CONTRACTS BECOMING INCREASINGLY POPULAR?

What is a strategic alliance?

Strategic alliances are not new. They range in size from handshake agreements between two companies to mega-deals involving many participants.

A strategic alliance is a business relationship between organisations in which they share risks, pool strengths, or integrate business functions for mutual benefit.

Each alliance partner in an alliance remains a distinct entity. The benefit of an alliance is not the length of the alliance relationship but rather the value each alliance partner receives under that alliance relationship.

Strategic alliances are growing in popularity. For principals, they are seen as a means by which they can reduce their reliance on in-house resources by utilising the expertise of contractors in the principal's business plans, allowing them to concentrate on their core business, yet retain a greater say in non-core, but important activities than would be the case with more traditional, "*arm-length*" outsourcing. This provides greater flexibility in service delivery. For contractors, they provide a mechanism by which they can forge closer, long term relationships with customers, often on more sensible, lower risk terms that still provide the opportunity for good profits as rewards for excellent performance.

Birthplace of alliance contracting

In the projects context, the strategic alliance concept got its start in the North Sea and in Alaska when BP (British Petroleum) saw it as the best way to take advantage of economies-of-scale, risk mitigation and achieving outsourcing goals while retaining its core competencies.

The popularity of alliancing in the oil and gas industry was attributable in part to the total quality management restructuring and outsourcing trends of the mid 1980s and early 1990s. During that period, the downturn of the industry (with a dramatic cut to drilling programs), the push to become more profitable combined with the lack of trained, experienced personnel led the oil companies and services companies to explore the increasingly popular new strategies for achieving the highest quality for the lowest overall cost. While the oil industry realised that service companies could supplement the oil companies' missing expertise if they were appropriately organised, many of the early alliancing and partnering relationships were formed for the wrong reasons and ended prematurely[1].

The development of strategic alliancing can be viewed in part as an enhanced outsourcing arrangement where the relationship strengthens over time as communication improves and trust is enhanced between the alliance partners.

Strategic alliance projects in Australia

In Australia, strategic alliances were first used on the Wandoo and the East Spar offshore gas developments.

In Wandoo, the operator of the Wandoo oilfield proceeded with the construction and installation of the Wandoo B platform using an alliance with four construction and design companies.

In East Spar, that project used an alliance between the operator and engineering/construction contractors for the design and construction of two subsea wells, a subsea gathering system and multiphase pipelines.

Some of the reasons given as perceived advantages of the alliance approach on those projects were:

- flexibility to vary development concept while maintaining schedule and cost;
- joint owner/contractor approach to safety and environmental objectives;
- non-adversarial approach with common, rather than conflicting, project objectives;
- reduced project management costs due to fewer contracts and interfaces and an integrated team;
- reducing bidding time and costs; and
- flexible access to contractor's resources thereby avoiding the need for the client to develop a large in-house engineering group[2].

In the rail and road context, strategic alliances have been used by the Rail Access Corporation in New South Wales and Westrail in Western Australia to outsource their infrastructure works and maintenance services on a competitive basis.

The RAC's 1997 Annual Report stated that:

"Alliancing Contracting will drive down the costs of works and maintenance and minimise disruption of services to our customers."

Strategic alliances have also been used by Sydney Water for the development of the Northside storage tunnel project, and by Woodside Petroleum for construction of floating oil production vessels for the Laminaria oil field in the Timor Sea.

ALLIANCE CONTRACTING - IS THERE A NEED FOR CONTRACTS?

While some strategic alliance participants have asserted that contracts are not an essential part of the alliance relationship, the prevailing view is that contracts remain a necessary feature of a strategic alliance relationship. Depending on the nature of the industry, the strategic alliance contract can be specifically tailored to reflect the special nature of the strategic alliance relationship in that industry.

The objective when drafting a strategic alliance contract is to create a contract which will actually assist the effective operation of such a relationship while remaining sensitive to the peculiar risks raised by a strategic alliance relationship.

Entering into a strategic relationship does not mean that the integrity of the risk allocation between the parties need be affected. Rather, the contract should provide the machinery appropriate to reflect the parties' real intentions concerning the strategic alliance relationship.

In public sector contracting, the contract is also especially important to show transparency of the contracting process and for public accountability reasons. Public sector organisations have to address not only probity concerns, Auditor-General audits and ICAC type reviews when contracting out, but must also show compliance with codes of practice established by the various governments (which deal with issues such as industrial relations, commitment to best practice and continuous improvement and the like).

In a recent article on a prominent project, it was stated that:

"one of the critical issues uncovered is that contract "alliances" work well when progress is good. However, when a contract falls behind and any bonuses (or penalties) have been used up, the incentive for a contractor to perform at optimum pace is lost."

All the more reason why a contract is required. For such a reason, a well drafted contract which clearly articulates the risk allocation negotiated by the parties, and on which the parties can rely as a "*safety net*" to protect their prospective rights, would appear a very prudent exercise.

Unlike partnering, the underlying concept of which is to supplement contractual relationships with a cohesive project team with an agreed set of goals and established procedures for resolving disputes in a timely and effective manner and for meeting project objectives by co-operation, team building and mutual trust, strategic alliances use clearly defined risk allocation with incentives to manage the process.

For example, the partnering charter is usually quite a separate document/agreement from the contract itself, whereas the alliance contract actually incorporates the expressions of co-operation, good faith, etc. into the contract itself.

SETTING UP A SUCCESSFUL ALLIANCE STRUCTURE

The parties to a new strategic alliance relationship should not underestimate the cultural changes likely to be required by them to achieve the necessarily more open relationship and the transition for parties who are used to working in a principal/contractor relationship to work as "*blended*" teams.

For a successful strategic alliance relationship, the parties must have a clear set of objectives, careful partner selection and an excellent working relationship between the alliance partners.

It is important that all of the strategic alliance partners have senior executives in charge of alliances. However, that goes beyond simply anointing an alliance "*godfather*". The strategic alliance partners will need to develop a class of alliance executive to build capability not only in existing contracts but also future strategic alliances.

In setting a successful alliance structure, there are various aspects which are notable:

- benchmarking;
- senior management involvement and commitment;
- evolution of the alliance;
- aligning the alliance with the contractor's strategy - top management must articulate a clear link between where it expects the contractor's future profit pools will be, how to capture them and where such an alliance fits in that plan;
- building systems and processes - alliance input need to come from middle and bottom of their organisation - while the alliance parties have draft alliance mission statements or project charters, there needs to be a fuller infrastructure which may include tools such as corporate policies, best practice guidelines and practice notes; and
- staff appropriately - to work effectively, teams must be balanced and personally compatible.

HOW DOES AN ALLIANCE PARTNERSHIP CONTRACT DIFFER FROM A STANDARD CONTRACT? WHAT IS ASKED FROM EACH ALLIANCE PARTNER?

Risk allocation

Strategic alliance relationships demand a departure from the traditional approach to contracting with respect to risk allocation. A contract which seeks to minimise the principal's risk exposure by shifting all risks to the contractor will hamper the development of the climate of goodwill and fair dealing conducive to a long term relationship.

The approach to the task of drafting an alliance partnership contract should be influenced by the following considerations:

- the alliance contract typically involves a far closer party/party relationship than that assumed by standard general conditions of contract;
- the contract should be structured to perform the role of a management tool, ensuring where possible the better management of the contractual/business relationship and the alliance partnership; and
- risk allocation should be considered in the context of delivering increased value for the alliance partners if the performance standards are met.

An alliance contract should at least include the following elements:

- a clear statement of the goals of the alliance relationship including the alliance strategy, project performance, project quality and project relations;
- details of the organisational and management structure including roles and functions of the different levels of management - typically an alliance board (which handles the overall "*big picture*" management, sets policy and acts as the arbiter of disputes) and alliance management teams (the day-to-day, hands-on "*coalface*" management);
- clear specification of the scope of work and the contractor's primary responsibilities including (as applicable) for design, construction, commissioning and maintenance, performance warranties, industrial relations, safety, environmental, quality, subcontractor management;
- the pricing regime, which will typically involve process for payment of margins, overheads and direct costs, with project accounts available for all parties' review on an "*open book*" basis, consistent with the nature of the alliance relationship;
- clearly defined key performance indicators including the monitoring and determination and adjustment to the remuneration structure by a "*fee modifier*" for meeting or failing to meet the key performance indicators;
- provision of security, where necessary;
- reporting and audit obligations;
- provision for the use and protection of intellectual property each party brings to the alliance and for the use and joint exploitation of intellectual property created during the project;
- risk management provisions including indemnities, limits of liability and insurance coverage; and
- default and termination provisions (including termination for default, termination for convenience and termination for "*deadlock*").

Strategic alliance contracts, whilst relatively new "*legal animals*", are increasingly being resorted to in both the private and public sectors. There is no suitable standard form contract available in Australia. This is not surprising, as clearly there will be wide variation between the type of services, the basis of remuneration and the criticality of timing of the services required.

Current forms of contracts

It is our view that to use a currently available standard form of general conditions for a strategic alliance contract without substantial amendment (in fact, virtual rewriting) would be highly inadvisable. In fact, a lawyer recommending such use would be running the risk of negligence.

The Capital Project Procurement Manual (published by the NSW government in 1993) states that:

> *"The current forms of contract generally in use within the industry have become too convoluted, user unfriendly and adversarial in nature. This situation reflects the management and administrative practices and experiences of the past. Their complexity, text and multitude of conditions are increasing the difficulties of the parties to the contracts, irrespective of whether they are representing the Principal or supplier.*
>
> *In addition, current contracts are not ideally suited to innovative procurement methods especially those that involve non-traditional commercial funding agreements or performance criteria."*

Contracts should be written in "*plain English*".

This makes contract administration easier, and is less likely to lead to disputes over the interpretation of the terms. Using "*plain English*" also helps both parties understand better the commercial risk allocation in the contract.

Build in flexibility

Parties should consider building some flexibility into the contract. This is particularly relevant the first time the principal outsources the activity in question, or the first time a contractor works on the principal's premises or with new equipment.

The obvious need for a "*learning curve*" should be openly acknowledged in the contract. For example, over time, in a project being undertaken on a principal's existing business premises, there may be less need for supervision of the contractor by the principal's own staff. Mechanisms encouraging free, two-way exchanges of information and ideas between operators and contractors should also be encouraged; for example, electronic links.

Alliance mission statement/project charter

One of the main tasks of the alliance parties is to draft and sign-off on an alliance mission statement or a project charter committing the alliance parties to broad project goals. The mission statement or charter is incorporated as part of the alliance contract.

Goals that are included in the mission statement or project charter typically encompass principles such as:

- working together towards the alliance parties' common objectives and building on a relationship of trust, openness and fair dealing between them;
- ensuring delivery of the project to meet or exceed the performance criteria set in relation to targets or key performance indicators for quality, cost, schedule and safety;
- managing the delivery of the project in a way acceptable to the principal and to achieve satisfactory commercial outcomes for all alliance partners.

Key performance indicators ("KPIs")

To resolve the potential difficulty regarding the regulation of the contractor's activities over the life of the strategic alliance relationship, the use of key performance indicators serves as a measurement and regulatory tool and an incentive function to contractors. Another term commonly used is "*business-as-usual*" ("BAS") indicators.

The type of KPIs used in each type of contract varies. Some contracts have a strong technical, safety, industrial relations and environmental emphasis - other may be driven by cost, time and quality criteria.

Traditionally, KPIs have been measured in quantitative/objective terms - it may be appropriate in certain circumstances to measure them by more qualitative/subjective indicators.

KPIs should also promote an on-going improvement process during the life of the strategic alliance relationship. In the course of a strategic alliance relationship, the value, purpose and relevance of KPIs used at the outset of the contract should be capable of re-assessment to facilitate improvement and realignment of interests between the alliance partners.

Legal considerations

A well drafted alliance contract, which sets out clearly the proposed machinery for the parties day-to-day interface, the agreed risk allocation and the scope of work to be performed can be a very effective tool for ensuring that the parties to the alliance have a sound legal as well as business relationship. However, it must be recognised that the increased interface at all levels between parties that is inherent in an alliance relationship undoubtedly has the potential for heightening the risk of other non-contractual legal consequences flowing from that.

One possible legal consequence of parties adopting a strategic alliance relationship is the potential for the existence of that relationship to be a factor in a court finding that there should be implied into their contract a duty to act in good faith to each other, or that the parties owe fiduciary duties to each other.

Australian courts have been reluctant so far to impose any general duty to act in good faith on contracting parties. At the very least such a duty is controversial, as shown by the two New South Wales Court of Appeal decisions *Renard Constructions (ME) Pty Ltd v Minster for Public Works* (1992) 26 NSWLR 234[3] and *Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney* (1993) 31 NSWLR 94[4], in which the judges expressed sharply differing views about a possible duty to act in good faith. It is likely, however, that a general trend towards implying into every contract a duty to act in good faith will emerge in Australian law. Such a duty is well recognised in the United States and in international contracts such as that promoted by UNIDROIT. The courts are beginning to give content and shape to the idea of good faith and fair dealing. For example, a duty to negotiate in good faith is now being recognised and courts, drawing on United States experience, can give some quite specific content to such a duty.

However, apart from involving an obligation to act reasonably in exercising contractual powers, it is far from clear at this stage what the full content of a contractual good faith duty is[5].

There has been empirical work done which shows that, at least in long term relationships, commercial players do not stand on their strict legal rights and do not necessarily behave as short term profit maximisers[6]. These studies have spawned the relational school of contract theory which examines contract, not as a number of one-off exchanges, but as long-term relationships which may involve "*the entangling strings of friendship, reputation, interdependence, morality and altruistic desires*"[7]. Relational contracts are dynamic and change over time. The parties realise that it is not possible to provide for every possible contingency ahead of time and they leave some matters to luck and trust. The parties may not necessarily expect full enforceability of the terms of the contract so long as there is substantial compliance with those terms.

In *Renard's* case, Priestly JA stated that:

"the time may be fast approaching when the idea of good faith, long recognised as implicit in many of the orthodox techniques of solving contractual disputes, will gain explicit recognition in the same way as it has in Europe and the United States."

In the United States, the Uniform Commercial Code 1-203 provides that:

"every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement".

Similarly, civil law countries such as Germany, France and Japan and international contracts all have good faith performance requirements[8].

Fiduciary duties

A fiduciary must act in the interests of the other party to the relationship and must conduct himself or herself in such a way so that there is no conflict between his or her duty and the other party's interests. This is to be contrasted with the normal assumption that applies in a contractual relationship where it is expected that each party will act in his or her own interests. The law imposes a fiduciary duty in certain well-known relationships such as solicitor and client and trustee and beneficiary.

In recent years, the courts have expanded the situations in which they have found fiduciary relationships to exist. For example, there is authority in Australia for the proposition that parties to a joint venture agreement may put themselves in a position whereby fiduciary obligations are imposed. Some commentators have suggested that it is likely that a court, if called upon to analyse a situation where parties to a contract have also been in a strategic alliance relationship, may find they have placed reliance on each other in the relevant sense to be bound by fiduciary obligations to each other.

It has been suggested that the identification by the parties (often in their "*alliance mission statement*") of their respective goals and their mutual objectives may add weight to the likelihood of such a finding. If a fiduciary relationship was held to exist between the contracting parties who have been in a strategic alliance relationship, then the parties would be bound by the principles of equity to avoid misusing their fiduciary position and making any unauthorised profit, and to avoid conflict of interest between their duty to the other party and their own interest.

Misleading or deceptive conduct

It is a mistake to assume that all the parties' legal rights are found in the express terms of the contract. Negotiations and documents which are not part of the contract may attract other legal rights, for example, rights under legislation such as the Commonwealth *Trade Practices Act* and the NSW *Fair Trading Act*.

For example, the *Trade Practices Act* forbids conduct in trade or commerce which is unconscionable (ss51AA, 51AB, 51AC), misleading or deceptive (s52) or which constitutes false representation (s53). Substantially, similar provisions are found in each State and Territory Fair Trading Act.

Estoppel and waiver

In addition, the conduct of parties to a contract, including representations made orally or in writing, may bring either or both of the doctrines of estoppel and waiver into play, which can also alter the parties' overall legal (as opposed to simply contractual) relationship.

It is vital that parties are aware that their conduct during negotiations and the course of their project may attract quite severe legal consequences, including liability for damages and the possibility that the relevant contract may be cancelled in whole or in part, or that the contract may even be varied by a court order. All of this applies irrespective of even the most comprehensively drafted "*entire agreement*" or exclusion clause. The courts have decided time and again that it is not possible to contract out of statutorily imposed standards of fair conduct (such as s52 of the *Trade Practices Act*).

Dispute resolution

Standard form contracts in the construction industry routinely make references to at least arbitration (or incorporate mediation and arbitration). Parties in a strategic alliance relationship should consider whether such provisions are appropriate, or whether they should be tailored to meet the needs of the alliance relationship.

In a strategic alliance relationship, it will often be more appropriate for the alliance parties to use an alternative dispute resolution process such as expert determination (single expert or a dispute review board) to resolve disputes which the parties (including via their representatives on the alliance board) are unable to resolve.

The alliance parties may specify in the contract qualifications for the independent experts (which can be different for different types of dispute), and set the timeframe and parameters for the provision of the information necessary to make the dispute resolution process effective.

However, if the strategic alliance relationship has strained to such a degree where decision making between the parties is deadlocked and the parties have to resort to formal dispute resolution, it may be more appropriate for a party to consider terminating the contract (provided the strategic alliance contract has provided for such a right).

The use of alliance contracting in Australia will undoubtedly raise some new legal issues but it is the overall responsibility of the courts to give effect to the expressed intention of the parties in a contractual relationship. If the parties have expressed themselves very clearly in terms of dealing with each other on a basis of good faith and fair dealing then the legal solution to any problem which may arise should reflect their expressed intention. One feature of alliance contracting is to provide specifically for mechanisms for resolving differences. Usually, a contract term will include a duty to negotiate around the difficulty. This type of provision can be given form and content by the law.

Acknowledgment

The authors appreciate the comments provided by Nick Seddon, Reader in Law, Australian National University during the course of preparation of the paper.

Footnotes

1. Loftspring P, *Alliancing: A Paradigm in Transition, Getting the Incentives Right.* Paper presented at the Partnerships, Contracting & Strategic Alliances Conference, New Orleans, 26-27 February 1997.
2. Campbell P and Minns D, *Alliancing - The East Spar and Wandoo Projects*, AMPLA Bulletin Vol 15(4) p202.
3. This case involved a construction contract incorporating NPWC Edition 3 (1981). The principal alleged that the contractor was in breach due to delays and the contractor was asked to show cause why the work should not be taken over. The contractor considered that the principal's action constituted a wrongful repudiation of the contract. It was established that the principal had acted unreasonably or dishonestly in the way it had used the show cause procedure and was accordingly in breach for wrongful termination of contract.
4. This was a building contract case in which the principal exercised its rights under NPWC Edition 3 (1981) and raised almost identical issues to those in the *Renard* case. It was held this time that the principal had properly used the show cause procedure and was, therefore, not in breach.
5. For example: good faith is defined in:
   - the New Shorter Oxford English Dictionary as "*honesty of intention, sincerity*"; and
   - the Macquarie Dictionary, 2nd edition as:
     "*1. honesty of purpose or sincerity of declaration: to act in good faith;*
     2. expectation of such qualities in others: to take a job in good faith".

   See also Stewart, I B, "*Good Faith in Contractual Performance and in Negotiation*" (1998) 72 ALJ 370.
6. S. Macauley, *Non-contractual Relations in Business. A Preliminary Study* (1963) American Society of Rev 55. Bede H & Dugade *Contracts Between Businessmen: Planning and the Use of Contractual Remedies* (1975) 2 Brit Jo of Law & Society 45.
7. MacNeil IR *A Primer of Contractual Planning* [1975] 48 S Cal LR 692 at 633.
8. See also UNIDROIT Principles for International Contracts Article 1.9. ❑