Deconstructing Adversarial Contracting: Towards Success-Focused Contracting

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May 31, 2011

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I. Introduction

Construction contracting today is rife with big, expensive disputes that suck the profit out of many deals. Disputes arise due to the nature of the construction industry where each project is unique and there is no such condition as stasis—conditions change after the price is set, aggressive schedules and milestones are the norm, external factors beyond the parties control impact performance, design and construction are imperfect and lower tiers fail to perform. The annual transactional costs of resolving construction disputes in the United States are estimated to be in the $4 billion to $12 billion range.[1] This estimate includes legal fees and costs, and does not include settlement amounts or consequential costs such as lost business.[2]

A significant source, and even a primary cause, of disputes[3] is the construction contract itself. Common sense teaches that contracting parties' chances of making a profit is more likely when a project is successful. Yet, today's EPC contracting process is adversarial across all parties at all tiers with each party seeking mainly to deflect risk and protect itself from liability rather than focusing on contracting for success. By diminishing the adversarial nature of the EPC contracting process, the contract may not have to be the trigger for so many of the disputes.

Diminishing the adversarial environment begins with fundamental changes in the contracting relationship. Drafting a contract that works "for" project success rather than "against" it is the first step. Success-focused contracting requires four shifts in the industry contracting model: (1) more and deeper party involvement in the process; (2) equitable risk allocation; (3) alignment of the parties' interests; and (4) proactive dispute resolution. This article discusses each of these shifts and how they can help minimize disputes in construction contracting.

II. Party Involvement

Blaming lawyers for the adversarial contracts is easy, and almost reflexive. Adversarial contracting is often a result of what lawyers perceive to be their fiduciary duty to their clients. The lawyer is bound to act in the best interests of its client. Absent client direction to the

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1 *Reducing Construction Costs: Uses of Best Dispute Resolution Practices by Project Owners*, Proceedings Report: Federal Facilities Council Technical Report No. 149 (The National Academic Press, Washington, D.C.), 2007, at 1.

2 *Id.*

3 See, e.g., J. Cletus Goetz & G. Edward Gibson, Jr., Construction Litigation, U.S. General Services Administration, 1980-2004, 1 Journal of Legal Affairs and Dispute Resolution in Engineering and Construction 1, at 12 (December 31, 2008) (Both NAVFAC and USACE identified interpretation of contracts as the primary cause of litigation.).

contrary, many lawyers construe the "best interests" of their client as crafting the legal equivalent of a flack jacket, deflecting liability and transferring risk. Party involvement means consideration of what a "successful" project is and how to craft contracts focused on achieving the Owner's particular performance objectives. The plural "contracts" is deliberately used because an EPC project's success involves not only the EPC contract but also depends upon coordinating the contractual relationships and the performance of downstream engineers, designers, subcontractors, and vendors.

Owners and lenders favor EPC contracting because it offers a single point of responsibility and accountability. Theoretically if something goes awry, the Owner and its lender have only one party to hold responsible, and the Owner avoids having to take sides when the designers and contractors blame each other. In practice, the single point of responsibility does not guarantee fewer or less costly disputes because it does nothing to eliminate or contain disputes arising from the various tiers of contracts under the EPC contractor. Once a dispute arises, if the amount in controversy is significant, attempts to transfer liability will result in involvement of upstream and downstream parties.

Party involvement means that the parties, rather than their lawyers, take responsibility for their contracts and engage in a discussion of the details with the other participants in the project.[4] The Owner and EPC Contractor need to take off their flack jackets and direct their lawyers to draft contracts that "work" for the project. This requires that the parties inform their lawyers as to what a "successful" project requires. Taking direction from the parties, the lawyers need to understand that the best interests of their clients may, in fact, be best achieved by a contract that is developed through a collaborative, rather than adversarial, process.

III. Equitable Risk Allocation

Due partly to the reliance on form contracts, the goal of achieving project success often is given little emphasis in the negotiation or drafting process.[5] The parties instead begin with an

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[4] *Reducing Construction Costs: Uses of Best Dispute Resolution Practices by Project Owners*, *supra* note 1, at 42. An example of Owner led contracting is the COAA EPC Contract 2005: Engineering, Procurement and Construction Contract, EPC Contract (Construction Owners Association of Alberta), 2005.

[5] *See* Joseph A. Huse, Understanding & Negotiating Turnkey & EPC Contracts (2nd ed. 2002) (It considers several "form" EPC contracts and considers the FIDIC contracts, particularly the Silver contract, in depth. The design / build contracts by the American Institute of Architects (AIA), the Association of General Contractors (AGC), the Design Build Institute of America (DBIA) all offer standard form design-build agreements. While these may be adapted for EPC use, substantial revision or creation of exhibits is necessary. The Construction Owners Association or Alberta (COAA), the Institute of Civil Engineers (ICE), the *Federation Internationale des Ingenieures-Conseils* (FIDIC) Red, Yellow and Silver Books are intended for use with EPC and turnkey projects. Each addresses the risks inherent in any construction contract, including without limitation, design, defective construction, scope changes, unforeseen or concealed conditions, *force majeure*, delay, access to site, labor interruption, bonding or other security, and environmental protection. Each allocates risk differently as between the Owner and EPC contractor, ranging from the Silver Book's transfer of virtually all risk to the Contractor to the COAA which tends to distribute a given risk to the party most capable of handling it.).

expressed or tacit presumption of mistrust.[6] Risk avoidance is currently one of the most important functions of the contracts. Absent supply/demand anomalies, the party with the power to hire routinely seeks to transfer as much risk as can be leveraged to the party seeking the work. This occurs at every tier. Each party negotiates for the purposes of protecting itself from both upstream and downstream other parties. The party to be hired will attempt to push back, but the result is often that the Owner transfers the risk to the EPC contractor,[7] and the EPC contractor crams the risk down to the lower tiers, where the entities can neither manage the risk nor mitigate the financial consequences. [8]

Any comfort gained by the Owner or EPC contractor from this process is illusory. When risk is transferred inequitably to a party that has little or no control over the risk or means of handling the risk, a technical or commercial issue can be quickly transformed into a "bet the company" dispute for that party.[9] Paradoxically, it is the quest of each party to protect itself from risk that produces and exacerbates disputes.

Moreover, the transfer of risk can become not just adversarial, but punitive. For example, there is a legitimate interest in requiring prompt notice of claims because it allows parties to mitigate damages. Contractually, it is sufficient to provide that a party is obligated to provide prompt notice and agrees to assume the liability of any costs that could have been avoided had it given notice promptly. However, contracts frequently and unnecessarily provide that a party waives all rights to any recovery if it misses the notice deadline by even a day. The practical effect is that an issue of mitigation of damages is effectively escalated to a battle for survival.

The alternative to the risk avoidance model is equitable risk distribution, which is the distribution of the risk to the party most capable of managing or controlling the risk.[10] It has been noted that equitable distribution of risk is the single most important element of dispute minimization.[11] This approach swaps risk allocation based on bargaining power for risk allocation based on the reality of the parties' ability to handle the risk.[12] When the risks are equitably allocated, the adversarial focus is minimized and parties can contract for success, rather than self-protection.

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6 Dr. Kris R. Nielsen, Experienced Based Recommendation on Risk Allocation for Both Owners and Contractors (November 21, 2006) (paper presented in Sao Paulo, Brazil, November 21, 2006 at the conference on Practical Strategies for Successful International Projects).

7 Huse, *supra* note 5.

8 Nielsen, *supra* note 6, at 7.

9 *Reducing Construction Costs: Uses of Best Dispute Resolution Practices by Project Owners*, *supra* note 1, at 3.

10 *Id.* at 13-14; *see* Nielsen, *supra* note 6, at 5-7.

11 *Id.* at 33.

12 *Id.* at 34.

IV. Alignment of the Parties' Interests

Instead of contracting with the purpose of shunning risk and liability, a contract can be used to align the interests of the parties towards achieving a collective goal – the success of the project. As with equitable risk allocation, when parties align their interests and recognize that their profit is tied to success of the project as a whole, disputes are less likely to arise.[13]

There are a number of models that help achieve aligned, success-oriented contracts. One of the earlier and more familiar attempts to align parties is partnering. Partnering is largely aspirational, rather than a restructuring of legal relationships.[14] The parties often have a separate "partnering agreement" which recites a willingness to cooperate toward completion of the project, and may establish committees and regular meetings to encourage cooperation. However, if the contractual relationships remain unchanged, then the success is contingent solely on the parties' goodwill. At the first dispute, the partnering collegiality often fades and the parties each begin to review their contracts for support of their position.

In addition to a willingness to collaborate, alliancing, another alignment model, involves contractual changes intended to benefit all parties if the contract is successful. The hallmark of alliancing is that the contracts are drafted so that the major parties share the economic gain and the pain. Compensation is structured so that everyone has skin in the game and that all share, based on predetermined allocations methods, in profit.[15] It is important to note that contracts that seek to align interests do not do so because the parties profit motive is abandoned in favor of the reward of good feelings that arise from a job well done. Although those feelings may arise, the underlying premise is that each party agrees to alliancing because each recognizes its own profit is largely dependent on success of the project, and the success is dependent on coordination and collaboration. Each individual participant should want its own contract to be drafted with the intent of achieving a successful project, and should want every other contract between all other participants to be written with the same intent. Parties to alliancing contracts believe it is smart business.

More recently, Integrated Project Delivery (IPD) has appeared. IPD is an umbrella term for project delivery systems which also encourages coordination by compensating all major stakeholders for a project well done and distributing the costs for failure. IPD begins with selecting the team; then establishes and prioritizes project goals; negotiates contract terms, including the project metrics, project management, risk allocation and a compensation system that reflect and enable the project goals; then the team executes a multiparty contract. Case

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13 *Id.*

14 Andrew Stephenson, Alliance Contracting, Partnering, Co-operative Contracting: Risk Avoidance or Risk Creation (June 6, 2000) (unpublished presentation).

15 *Reducing Construction Costs: Uses of Best Dispute Resolution Practices by Project Owners*, *supra* note 1, at 14.

studies of IPD projects reveal that "true" IPD projects are a rarity.[16] Nonetheless, some major industry and professional organizations now offer standard form multiparty contracts.[17]

While the alliancing and IPD contracts are still a rarity, at least partial alignment of parties' interests is currently being accomplished by Building Information Modeling, or BIM, agreements. BIM is a game-changer in construction contracting because it intentionally blurs the traditional line between design and construction. Common law and insurance policies primarily characterize liability based on whether the damages are traced to design or to construction. Implementation of BIM technology is predicated shared data for the purpose of integrating, and thereby improving, the planning, design, construction and operation of the facility.[18]

Information on the number and kinds of projects using BIM and on the particular use of BIM in those projects is largely anecdotal. One study identified at least 21 uses of BIM, all of which were based on collaboration of the participants.[19] BIM is forcing and will continue to force a reassessment of the traditional design versus construction basis of liability. The industry and legal community already recognize that use of BIM has legal implications that cannot be ignored. Both standard form and custom contracts are being developed to address the protocols and responsibilities and to allocate liabilities arising from the use of BIM. The terms of BIM agreements, like other contracts, should be informed by business needs. This includes input from those with understanding of the BIM process and use of BIM. For example, the BIM Project Execution Planning Guide maps the project execution process in detail, including developing information exchange worksheets, and considering the necessary infrastructure for implementing BIM, and providing templates.[20]

V. Proactive Dispute Resolution

Contracts are intended to create predictability in the commercial transaction. Predictability requires effective dispute resolution processes. Parties need to know that the bargain will be upheld and disputes will be resolved as provided in the contract in a predictable, impartial manner. Proactive dispute resolution means the parties consider the kinds of disputes that can arise during construction and preselect the appropriate methods for resolution.

Many contracts prescribe tiered resolution of issues that begin with consideration of the issue in the field. If the issue cannot be resolved in the field, it is funneled up to project

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16 *See IPD Case Studies*, AIA Minnesota School of Architecture (University of Minnesota), February 2011.

17 *See ConsensusDocs 300: Standard Form of Tri-Party Agreement for Collaborative Project Delivery*, ConsensusDocs, 2007.

18 *See BIM: Project Execution Planning Guide: Version 2.0*, The Computer Integrated Construction Research Program (Pennsylvania State University, University Park, P.A.), July 2010.

19 *Id.*

20 *Id.*

management, and then, if necessary, to executive review. The next step is usually mediation where the parties work with a neutral to resolve their issues.

If mediation is unsuccessful, most contracts place the dispute in the hands of third parties. At this stage the control of the dispute is surrendered to strangers to the contract. Although the parties would never agree to flip a coin, resolution of disputes by strangers to the contract is often no more predictable. Those strangers, whether it is a jury or an arbitration panel, have virtually unfettered authority to interpret the parties' bargain. More importantly, those strangers have "no skin in the game." Juries are dismissed and arbitrators get paid no matter how arbitrary the decision. Indeed, Federal Arbitration Act (FAA) holds that the arbitrator's failure to follow the law or the contract provisions is not grounds to vacate or appeal.[21]

Parties can contract to employ different procedures for different types of disputes. While commercial disputes may be best handled by executives with lawyer assistance, a technical dispute may be more expeditiously resolved by a mutually selected independent expert such as a neutral Dispute Resolution Board (DRB). These neutrals may be selected at the start of the project and then monitor the project through periodic site visits and meetings. If a dispute develops, the neutrals are ready to step in and make review and recommendations on a "real time" basis.[22] Most DRB findings are advisory, not binding. Still the Dispute Review Board Forum, DBRF, boasts that of 1500 recommendations on North American projects, "all but a handful have been adopted by the parties".[23] The key to the success of DRB is that the neutrals are perceived by all parties as knowledgeable and of unquestioned integrity.

Proactive dispute resolution along with the equitable distribution of risks and alignment of party interests can help minimize disputes by enabling issues to be addressed quickly as they arise and before they grow into "bet the business" disputes. Proactive dispute resolution and retaining more control of the procedures increase the predictability of the process and the decisions.

VI. Conclusion

Construction will continue to be rife with disputes so long as the contracts are drafted, first and foremost, to protect parties from each other and from liability rather than achieving a successful project. Unless parties become involved in discussions of what is needed for a successful project and direct their counsel to contract to that end, the adversarial posture will be perpetuated and the benefits of success-focused contracting will remain out of reach.

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[21] *See Hall St. Assocs., L.L.C. v. Mattel, Inc.*, 552 U.S. 576 (2008).

[22] *Reducing Construction Costs: Uses of Best Dispute Resolution Practices by Project Owners*, *supra* note 1, at 16.

[23] http://www.drb.org/FAQ.htm