

STRONGER TOGETHER

TRI-PARTY AGREEMENTS

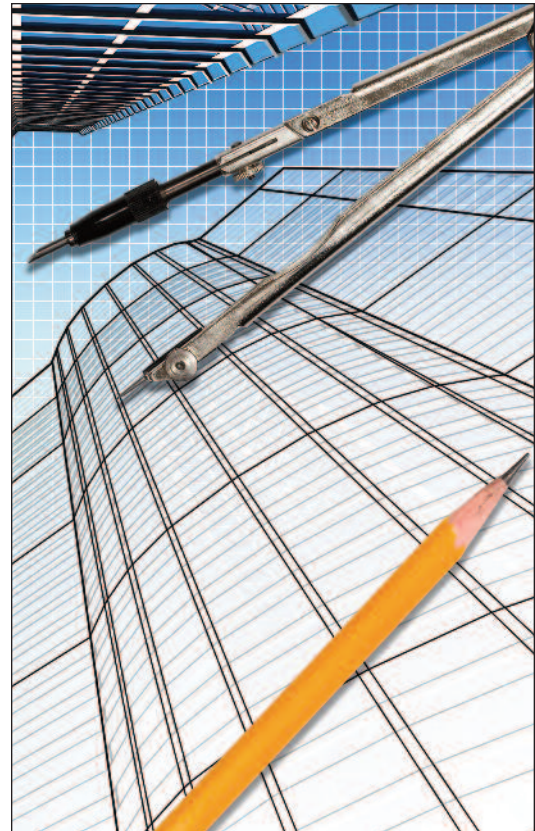
Joining forces to gain advantages not possessed by a single individual or entity is a common and age-old tactic. In the construction sector it is a relatively recent strategy, evidenced by rising interest in project delivery approaches based on the collaboration and integration of the roles and responsibilities of project owner, design team and constructor. These collaborations require the careful crafting of insurance coverage so that all parties are protected.

SHARING THE PAIN - AND THE GAIN

In broad terms, tri-party agreements establish a cooperative business relationship where the project owner, the design team and the constructor collaborate to move a project from the design developmental stage to the completion and hand-over. All participants share responsibility for project risks as well as the gains derived from a successful outcome. Decisions are made on a unanimous, tri-partite basis – the corollary of which is that the participants agree not to bring legal actions against one another (with limited exceptions) in the event the project does not go according to plan.

A traditional design/bid/build and design/build contract is based on the theory of risk allocation, wherein risk is transferred to the party considered best equipped to manage it. Tri-party agreements, on the other hand, are premised on the parties *jointly embracing* the risks associated with a project. Instead of transferring risk between participants, in the tri-party agreement, the parties collectively assume and manage the risks within a flexible project delivery environment. Key features of such an agreement are:

- The parties share responsibility – on a joint and several basis – for performing the work and generally assume collective ownership of all risks associated with delivery of the project.



- The project owner pays the non-owner project participants for their services on a 100% open book compensation model that covers the project costs and project-specific overheads, a fee to cover corporate overheads and normal profit, and an equitable share of the pain (the risks of loss or liability) or gain (a share of project cost-savings or operating profits), depending on the project outcomes compared with the parties' joint targets. The downside to the non-owner project participants is usually limited to the loss of the corporate overheads and normal profit.
- Executive leadership is through a joint body (variously referred to as the Management Group (ConsensusDOCS), Project Executive Team (AIA), Alliance Board or Alliance Leadership Team)

comprised of senior representatives of the project owner and non-owner project participants and in which all decisions are unanimous.

- Day-to-day project management is by a joint management team (typically called the Project Management Team or Alliance Management Team) supported by various seamless integrated project teams in a “best-for-project” culture where all project members work together.
- The parties agree to a “no blame, no dispute” culture wherein, should problems arise or loss occur, responsibility and loss is shouldered equally.
- The parties agree to resolve issues or disputes within the alliance (by escalating up to the executive leadership group) with no recourse to litigation except in the case of limited circumstances, such as willful default.

HYBRID VS. PURE AGREEMENTS

Some agreements are “hybrid,” similar to “pure” alliances in terms of management and remuneration structure (usually based on performance measured against key performance indicators or KPIs) and with similar obligations of cooperation and good faith; but different in that the hybrid alliance usually requires the non-owner participants to retain discrete liability for breaches of their obligations under the agreement. Breaches of these obligations can be specifically enforced by legal action.

TRADITIONAL VS. TRI-PARTY AGREEMENTS

Projects may be suited to tri-party agreements if:

1. The project is large – and involves numerous complex and unpredictable risks with complex interfaces
2. External threats or opportunities are such that can best be managed on a collective basis
3. The output specification cannot be clearly defined at the outset because of such issues as technological change, political or environmental influences
4. Timeframe is limited

Traditional design/bid/build and design/build procurement approaches are generally better suited to projects where the project risks can be clearly defined, costed and allocated among the parties.

THE STRUCTURE OF A TRI-PARTY AGREEMENT

In addition to customized contracts used by some project owners, a number of standard contract forms have been published, including AIA C191 and ConsensusDOCS 300. These, together with similar contracts published in the UK, Australia and Canada, as well as by FIDIC (International Federation of Consulting Engineers), are variously referred to as Alliancing, Partnering, Collaborative Project Delivery and/or Integrated Project Delivery (IPD) contracts, and, generally, they share similar terms and conditions:

The project alliance model began in the construction industry with North Sea oil and gas projects in the U.K. British Petroleum formed an alliance with seven other partners and planned and executed the development of the Andrew Field project, located 230 kilometers northeast of Aberdeen. This alliance resulted in a shared cost savings of 20-30% and time savings of approximately six months, showing that if all parties to the project were willing to work together, pooling their collective resources and ideas, each party could walk away a winner.

This approach has been employed on an increasingly wide range of projects, including many projects for Sutter Health, London Heathrow Terminal 5 and Sydney’s North Water Tunnel.

THE “NO DISPUTE” CLAUSE

The parties agree to “release each other from any liability at law or in equity” (ConsensusDocs language) for a failure to perform any obligation, or to discharge any duty, arising from or in connection with the tri-party agreement. The principal exception is the event of willful default (see below).

Instead of finger pointing, the parties work together to overcome a problem as cost effectively as possible, an approach intended to foster more innovative, interactive and cooperative design and construction solutions unhampered by liability apportionment issues.

This clause does not necessarily prevent disputes. The objective is to have disputes amicably resolved through discussions (which might be escalated from the project to the executive leadership team for unanimous resolution). Some agreements also make provisions for processes to break deadlocks through mediation or some other dispute resolution mechanism. If one of the parties is negligent or fails to perform and corrective actions are required, the intent is for all parties, together, to implement such remedial action, with mitigation costs becoming a project cost shared by all – with clear ramifications respecting the gainshare for all parties.

Given that most litigation under traditional project delivery methods involves owners/principals suing contractors and designers for negligence or breach of contract arising from defective workmanship or negligence, many project owners find the no-dispute clause problematic. Some of the standard contract forms accommodate project owners who prefer an agreement without a “no dispute” clause, but such contracts significantly weaken the integrity of the tri-party model and raise the question: Why bother with a tri-party agreement at all?

WILLFUL DEFAULT

Generally construed to include:

- Deliberate or reckless conduct the party knew or ought to have known would cause harm to another party
- Failure to honor an indemnity
- Failure to make a payment that has fallen due under the agreement
- Material failure to effect required insurances
- Intentional failure to honor “open book” audit obligations
- Intentional breach of obligations with respect to third parties’ intellectual property rights
- Fraudulent conduct

In any of the above examples, the party in default would be in breach of their obligations under the agreement and could

be the subject of a liability claim by the other parties. In the absence of any willful default, however, the negligence or defective work of a participant will be subject to the no dispute clause.

GOOD FAITH AND FAIR DEALING

The parties are each required to “accept the relationship of mutual trust, good faith and fair dealing” and generally embrace some or all of the following:

- An obligation on the parties to cooperate in achieving the contractual objectives
- A duty to act honestly
- A duty to recognize and have regard to the legitimate interests of the other parties in benefiting from the bargain
- A duty to comply with reasonable standards of conduct in regard to the interests of the parties
- An obligation not to act in bad faith

Clearly, in the context of a tri-party agreement, any breach of this duty is likely to be construed as willful default. Were such default to result in one or more of the injured parties suing for damages, damages in tort cases may be recovered for all losses that the injured party incurs as a consequence of the other party’s misconduct and hence could potentially be significantly greater than the damages that might be awarded under a straight breach of contract action. (More so than in the U.K. or Australia, the duty of good faith is well established in the U.S., and the courts have established that breach of the duty can constitute a breach of contract and may also amount to a tort under certain circumstances.)

TERMINATION FOR CONVENIENCE

A termination for convenience clause is also typically included in tri-party project agreements. This clause usually provides the project owner the right to terminate “without cause” (AIA). The project owner can therefore terminate the contract without any breach of obligations or willful default on the part of any of the parties. This clause gives the



project owner the right to abandon the project, or part of it, permanently or temporarily, at any time.

Given the unrestricted discretion this affords the project owner, the agreement will also usually include a compensation protocol for the non-owner parties. They will typically be paid for work carried out to the point of the termination. Provisions may also be made for payment, in whole or in part, of “gainshare” or other goal achievement-based compensation.

It is prudent for non-owner parties to carefully examine the agreement to determine their entitlements in the event of termination for convenience.

INSURANCE REQUIREMENTS

A tri-party project agreement usually provides for the following types of insurance coverage:

1. A general liability policy to cover liability from third-party claims for personal injury or property damage
2. A builder’s risk policy to cover the loss and damage to the project works under the agreement
3. A professional liability policy to cover the parties’ liability arising from an act, error or omission in the performance of professional services under the agreement

Most tri-party agreements also require other insurances, such as workers’ compensation and auto insurance, to be placed by the individual parties on their own behalf until the expiry of the defects liability period.

The agreement would normally require that all the participants be named as an insured under each policy. Unless an incorporated legal entity (JV or LLC) has been established, each participating entity would be named individually.

PROFESSIONAL LIABILITY INSURANCE

The most serious exposure that is faced by the parties is probably the failure by one or more of the alliance team members to fulfill their professional obligations.

Traditional professional liability policies cover professionals for acts, errors or omissions in their performance of professional services. These policies are written on a claims-made basis requiring that a demand by a third party be made in order to trigger coverage of the named insured. According to Victor O. Schinnerer in *Concepts in Risk Management*, over 75% of claims against design professionals have been made by project owners and contractors – an effort to change this dynamic is one of the underpinning principles of tri-party agreements.

In tri-party agreement projects, the “no dispute” clause will inhibit the response of a traditional professional liability policy and will only be triggered in the event of willful default or insolvency. The clause effectively releases each project participant from any liability for a failure to perform their obligations under the contract, and in the absence of a demand the policy cannot respond.

While such risk sharing may be acceptable contractually, it may not be acceptable from the perspective of public law. State statutes and regulations clearly proscribe requirements with respect to the professional licensing of individuals performing design services and implement a range of protections for public health, safety and welfare.

The tri-party agreement participant(s) providing design services – and particularly the lead designers – will therefore retain

professional liability risk beyond the contract, which must be accounted for. In the current professional liability market, this risk needs to be addressed on a manuscript basis integrating elements of third-party coverage, mitigation of loss, and potentially latent defect coverage to address post-completion issues. ■



FEELING THE SQUEEZE

CARRIERS CRACK DOWN ON LATE CLAIM REPORTING

The market has changed. Money is tight; belts are tighter. Carriers are feeling the squeeze and responding by taking hard looks at when a claim *is* reported and when it *should* be reported. It seems prudent, therefore, to review the reporting requirements under your Professional Liability policy.

The policy is a claims made/claims reported policy. The wording varies, but in general, these are the coverage triggers:

- The claim is made against the insured during the policy period.
- The claim is reported to the insurance carrier during the policy period, or within 60 days of the expiration date of the policy.

This additional 60 days is called the Extended Reporting Period.

- The actions that give rise to the claim occurred after the retroactive date.

Most policies also have a “Circumstance” Provision or Definition indicating the insured should report any circumstances that they believe may “reasonably develop into a claim” or “a fact or situation from which the insured may reasonably expect a claim to occur.” This Provision covers a situation that arises prior to when a third party “demands money or services as a right,” which is the definition of a claim. This Circumstance Provision or Definition calls for greater diligence in ensuring that claims and potential claims are properly reported to the carrier.

The intent of these Circumstance Provisions or Definitions of Circumstance is to

encourage insureds to pro-actively report a potential claim and provide them with expert assistance in the hope of avoiding the development of an actual claim. Generally, matters reported under these Provisions are identified as “Loss Prevention,” “Pre-Claim Assistance” or “Free Pre-Claim” files. Historically, these files were handled in a manner where such things as responding to subpoenas for records or depositions were at no cost to the insured, were not subject to the policy deductible nor did they erode the policy limits. The theory was that “spending \$2,500 to avoid a claim is better than spending \$100,000 defending a claim.”

The other reason for the Circumstance Provisions and Definitions is to try to prevent the designer from inadvertently doing something that could inhibit the defense should a claim to develop, or imperil coverage that potentially applies to the claim. Let’s take a walk through one scenario:

The designer is advised of a catastrophic accident that has occurred on the project: a wall has collapsed causing serious injuries and deaths. The designer may be asked to visit the site or even respond to questions relative to its designs or activities on the jobsite. The Pre-Claim Assistance or Loss Prevention aspects of the policies allow for the designer to report the matter to its carrier and be provided with assistance, either by the A&E claim specialist or an assigned attorney specializing in defending design professionals. The designer receives the assistance needed and has an increased chance of avoiding a claim.

Since the economy has turned sour, carriers are paying closer attention to what designers are doing before they report the matter to their broker, who in turn must report to their carrier. Insurance carriers are getting stricter about what they consider an acceptable level of involvement in discovering, investigating or looking for ways to address potential problems on a project. The result is an increase in the number of reservation-of-rights letters and even denials for improper notice.

The fact that you had continuous coverage with one insurance carrier for the entire period at issue should resolve the problem. Yes? No! Some carriers interpret the technicalities of a policy to mean that the claims made/claims reported activity must take place within a single policy year. Again, there seems to be a greater frequency of reservation-of-rights letters and denials on these points.

To further complicate the situation, some states indicate that the delay in reporting must “compromise the insurance carrier’s ability to defend the liability issues.” Other states have no such requirement, and the mere delay in reporting the matter is adequate for the carrier to extricate itself from the obligation to provide a defense or pay a claim that later develops.

The moral of this story is that it is in your best interests to report matters promptly where you believe the facts or circum-stances could potentially result in a claim. From the carrier perspective, it seems that the preference would be to open a pre-claim or loss prevention file and close it without payment than to have the designer do anything that would potentially imperil coverage.

Therefore, we recommend that you:

- Be cognizant of your Professional Liability coverage policy period, including the 60-day reporting Tail. Don’t allow the matter to linger unreported too close to the expiration of the current policy, even if you are intending the renew coverage with your current carrier.
- Promptly contact your broker if a situation arises on any project prior to any actions to explain, admit fault, mediate, negotiate, finger-point or recommend fixes or alternatives.
- Understand that there is a huge downside to delaying to report a claim or even a potential claim. Whatever you imagine you may save in premium based on loss history will be more than lost if the matter develops into a claim and your insurance carrier opts to deny it.

The moral of this story is that it is in your best interests to report matters promptly where you believe the facts or circumstances could potentially result in a claim. From the carrier perspective, it seems that the preference would be to open a pre-claim or loss prevention file and close it without payment than to have the designer do anything that would potentially imperil coverage.

REPORT, REPORT, REPORT

In these volatile economic times, we can ill-afford to allow issues to arise during the dispute resolution process that may inhibit your ability to get the claim behind you. The adage “The doctor who treats himself has a fool for a patient” applies equally well to the designer who thinks he/she can fix problems on the jobsite.

- Don't play with your policy period relative to reporting claims.
- Be very careful of any activity other than collecting adequate information to report the matter to your carrier for fear of imperiling coverage.
- Do not discuss the liability issues, admit to any fault or commit to any fixes, payments or additional services until you have discussed the matter with your insurance provider.
- When in doubt, REPORT.

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