

AACE
INTERNATIONAL
RECOMMENDED
PRACTICE

67R-11

**CONTRACT RISK ALLOCATION -
AS APPLIED IN ENGINEERING,
PROCUREMENT, AND
CONSTRUCTION**

SAMPLE

AACE
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AAACE® International Recommended Practice No. 67R-11

**CONTRACT RISK ALLOCATION – AS APPLIED IN
ENGINEERING, PROCUREMENT, AND CONSTRUCTION**
TCM Framework: 7.6 – Risk Management

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Note: As AAACE International Recommended Practices evolve over time, please refer to www.aacei.org for the latest revisions.

SAMPLE

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Disclaimer: The opinions expressed by the authors and contributors to this recommended practice are their own and do not necessarily reflect those of their employers, unless otherwise stated.

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INTRODUCTION

Scope

This recommended practice (RP) of AACE International defines the contract risk allocation principles as applied in engineering, procurement and construction (EPC). Such principles address for example; contract basics, legal risk allocation principles, general risk allocation principles, typical contract forms, common contract risks, and quantitative contract risk assessment. Much of the discussion focuses on construction; however, the principles apply to contracts for any element of an EPC project.

Purpose

This RP is intended to provide guidelines for making equitable contract risk allocation that reduce the potential for disputes and enhance the likelihood for project success.

Background

This RP summarizes and clarifies contract risk allocation practices in the context of the *TCM Framework* and risk management processes. It has been developed as a reference & overview document and may not be relied upon as legal or specific risk action advice. In addition, it is recommended to seek the advice and input of experts in contracting, claims, and dispute resolution as appropriate.

RECOMMENDED PRACTICE

The Contracting Process in the Construction Industry – An Introduction

Construction often involves numerous contracting parties, technological challenges and difficult working conditions. As a consequence, the allocation of contract risk is typically a controversial process with each party attempting to reduce negative risk as much as possible. Effective risk allocation can provide the foundation for good working relationships, which should ultimately benefit any construction project. All parties to a construction contract will find more benefit in being more risk aware.

Contractual risk transfer is a risk treatment practice within the risk management process that involves the allocation of risk among contracting parties. When performed effectively, risk transfer equitably allocates risk among parties according to their ability to control and insure against risk.

Construction contracts, both prime and major subcontracts, are often the most important documents on an EPC project. This is certainly true if a contract covers the entire EPC scope. The contract provides the means to clearly define the roles and responsibilities of each party so that it establishes which has assumed, negated or excluded a particular project risk. All parties to a contract should be mindful that risks can never be fully transferred, completely allocated or wholly assigned to one party.

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Inappropriate Risk Allocation

Attempts to protect the party with the higher bargaining power typically results in one-sided onerous contracts that generate self-inflicted (iatrogenic) risk. Examples may include:

- A potential reduction in the quality and/or quantity of bidders as they may seek opportunities elsewhere.
- Failure to recognize and allocate risk.
- Bidders unable to recognize and price for inequitable contract terms may submit a bid price or duration that later proves too low or short.
- Disputes (in an attempt to recoup losses).
- Contractor insolvency (further driving up cost and schedule delay while an alternate contractor is sought).

The Construction Industry Institute (CII) defines ^[3] inappropriate risk allocation as:

“The practice of allocating risk without separately considering which party may be in the optimum position to evaluate, control, bear the cost, or benefit from the assumption of the risk.”

Contract Negotiations

Negotiation skills are beyond the scope of this RP, however, during the pre-meeting or pre-negotiation period it is very important to develop a negotiating position based on fact-finding and analysis. Parties must begin managing threats and opportunities long before any contract is signed. Beginning with the earliest procurement and contracting strategy development and continuing into contract planning for each specific negotiation, strategic questions should be posed; e.g. what defines a acceptable outcome and what are the opinions of key stakeholders on critical issues?

Key pre-meeting objectives to be defined include:

- The initial offer;
- Goal for settlement; and
- The walk-away (or no deal) point.

In addition to strategic planning, tactical planning should determine the approach and technique to use. When possible, a collaborative problem solving approach is recommended.

Prequalification of bidders is important to understanding the risk allocation process; including but not limited to, the review of financial statements, public records, visiting relevant locations and speaking with parties who hold relevant past experience, etc.

Risk allocation is considered optimal when an agreement has been reached to allocate the three attributes, price, quantity, and remedy, in favor of the party most able to manage the underlying uncertainty.

Contract Law – An Overview:

Typically, in contracts there are two parties. A *promisee* is a person to whom a promise is made and a *promisor* is a person who makes a promise.

When a binding contract is prepared, an element of risk is consequently reallocated between the parties in some measure. For example, by making an agreement to provide goods or services, the promisee is likely to have transferred his or her risk of nonperformance to a promisor who is much better placed to be able to manage all

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associated risks. Prior to placing a contract, time is well spent verifying that risks are not transferred to a party that is unable to manage the uncertainty in question.

The optimal allocation of risk depends on the unique circumstances of the project. There may be situations in which traditional risk allocation practices may need to be modified in order to adapt to the project objectives. Therefore, great care should be taken not to run afoul of traditional logic that may attempt to dictate that, "standard forms can't be amended", "we've doing business this way for years" or "this is the way it has always been done".

When negotiating contracts, all stakeholders should read, analyze and understand their obligations. Professional services should be sought as required to ensure compliance with applicable laws and special statutory risks such as the *Foreign Corrupt Practices Act and Export Administration Act* (anti-boycott provisions). A well prepared contract will effectively balance threats and opportunities for each contracting party. A potential risk imbalance may be addressed by a proportional risk premium.

Risk Allocation Considerations and Principles

Inappropriate risk allocation is an industry-wide issue. The following list of risk allocation considerations helps negotiating parties decide which party should assume each particular risk. They are intended to get both contracting parties to consider the most important risk allocation concepts that have the most potential of being overlooked or disregarded.

Legal Risk Allocation Considerations:

- Courts may construe provisions exactly as written unless they are against public policy or statute.
- Courts may construe a contract provision in a manner that will do substantial justice to the parties.
- By signing a contract you have accepted what is in it.
- Contractual ambiguities may be construed against the drafting party.
- General disclaimers and ambiguities may be unenforceable.
- Contractual provisions cannot re-allocate intentional wrongdoings or illegal activities.
- If the contract is silent regarding damages, the offending party may be held responsible for "reasonably foreseeable" damages.

General Risk Allocation Principles:

- Many risks cannot be eliminated but they can be controlled.
- Eliminating one risk may cause another risk to arise.
- Care should be taken to evaluate risk interdependencies and predict the "domino effect" or cumulative impact if one interdependent risk should occur.
- Optimum allocation of risk may only be achieved through cooperation or shared responsibility.
- Ignoring a risk will not eliminate its potential impact.
- Risks that are not contractually allocated will be assumed, knowingly or unknowingly, by one or both of the contracting parties.
- Optimum allocation of risk is likely to vary from project to project.
- Any party may be able to assume a risk if:
 - a) they understand the underlying cause and subsequent consequence of a risk,
 - b) they are granted an appropriate risk premium for taking responsibility or ownership.