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# The importance of standard form contracts

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## Introduction

Parties entering into a contract for the construction of a major facility can use general conditions in one of: (a) a standard form contract (such as one of the AS4000 suite of contracts), (b) a standard form with some terms modified, or (c) a “bespoke” contract which has been written specifically for the particular features of the construction project at hand.

It is usually the employer (employer) who invites tenders for construction, and it is normal for such an employer to select the general conditions of contract it proposes to use for the construction contract. Many employers in Australia, perhaps the majority in respect of major resource projects, put forward bespoke contracts prepared by one of the major law firms experienced in construction contracting. It is suggested that such a preference for a bespoke contract is based on a view that none of the applicable standard form contracts adequately looks after the employer’s interests, and that the usual risk allocation between contractor and employer embodied in standard form contracts is unsatisfactory from the employer’s perspective. It is submitted that a substantial driver of an employer’s desire for a bespoke contract is a perception that such a contract can shift more risk to the contractor than would be the case under most standard form contracts.

The thesis of this paper is that, whilst such risk “reallocation” may have superficial attractions, the use of bespoke contracts with unbalanced risk allocation in preference to standard form (perhaps modified) contracts, generates other risks and costs for the Employer.

## Appropriate contract terms

The answer to the question “what are the most desirable conditions of contract?” for a particular project no doubt depends on whom the question is addressed to, in the context of the particular project. In the absence of the constraints of what can realistically be achieved in the marketplace, it is suggested that typical contracting parties on either side of the table might respond along the lines of:

- Employer: conditions that deliver a complete project of the highest quality for the lowest contract price,

to be completed in the shortest time with all unforeseen risks the responsibility of the Contractor.

- Contractor: conditions that unambiguously define the required scope and quality of the work for the highest contract price, to be completed within a time that is sufficient to carry out the work with available resources and allowing for contingencies, with unforeseen risks the responsibility of the employer.

Clearly, any such objectives of the parties are incompatible, and are unlikely to be attainable in any contract that both parties would be prepared to enter into. The more reasonable and constructive question to ask is: “what are the most appropriate conditions of contract that are most conducive to a successful project?” In common with many other commentators, this author suggests that part of the answer to that question is the use of the principles of balanced risk allocation, in which each risk is allocated to the party best able to manage it. In many instances these can be achieved in a (modified) standard form contract, of a type appropriately selected for the desired form of project delivery (eg construction only, design and construct, management contracting etc).

The Abrahamson principles of balanced risk allocation,<sup>1</sup> well known to construction lawyers, are widely regarded as the basis of “balanced” or “fair” or “efficient” risk allocation. Many standard form contracts are based on the explicitly stated principle of balanced or fair risk allocation, eg the Australian Standard 4000 series,<sup>2</sup> the US Consensusdocs,<sup>3</sup> the UK New Engineering Contract,<sup>4</sup> the European Engineering Industries Association,<sup>5</sup> the International Chamber of Commerce,<sup>6</sup> the Baltic and International Marine Council<sup>7</sup> and contracts for the UK offshore oil and gas industry.<sup>8</sup> The principle is also espoused by government procurement agencies in the UK,<sup>9</sup> Australia<sup>10</sup> and the USA.<sup>11</sup> Many writers suggest that adherence to the principle of balanced risk allocation enhances the prospect of successful contracts, by encouraging contractual performance that minimises adverse outcomes and thereby reduces dispute.<sup>12</sup>

It has been suggested that the traditional approach to construction contracts leads to aggressive and adversarial relationships that result from the type of contract the client puts in place.<sup>13</sup> The more recent approaches of partnering and alliancing that originated in the oil and gas industry, focus on contractual conditions which encourage cooperation and alignment of the employer's and contractor's objectives, through mechanisms such as gain and pain share and incentivisation to change traditional adversarial behaviours. However, traditional forms of construction contracts are still appropriate for many projects, and it is in these projects that the use of standard form contracts may be the most appropriate.

## Standard contract forms and "bespoke" contracts

### *Standard form contracts*

Typically, a standard form contract is the result of a collaborative effort of a number of people with a range of perspectives on how such contracts have operated in the past, and how they should operate in the future. Most such standard form contracts are the result of an evolutionary process, in which successive editions take account of previous operational experience and the difficulties of interpretation or implementation that have been identified by courts in the published case law, or by changes in relevant legislation.

Part of the evolution of standard form contracts over the last twenty or thirty years has been the recognition that different types of construction contracts have distinctly different requirements, and that standard form contracts should be prepared accordingly. The range of procurement options now in use for major projects demands a greater variety of contractual provisions than are provided by a single standard form contract. Whereas in the past a single standard form contract was widely used for construction work, project experience has demonstrated the pitfalls of using a standard form contract in circumstances for which it was not designed.<sup>14</sup>

The following list of Australian Standard (AS) contract forms indicates the range of current construction contract and subcontract types used in Australia:

- AS 4000-1997 General conditions of contract
- AS 4901-1998 Subcontract conditions
- AS 4301-1995 General conditions of tendering and tender form for design and construct contract
- AS 4302-1995 Form of formal instrument of agreement for design and construct contract
- AS 4902-2000 General conditions of contract for design and construct
- AS 4903-2000 General conditions of subcontract for design and construct
- AS 4905-2002 Minor works — Contract conditions (Superintendent administered)

- AS 4906-2002 Minor works — Contract conditions (Employer administered)
- AS 4910-2002 General conditions of contract for the supply of equipment with installation
- AS/NZS 4911:2003 General conditions of contract for the supply of equipment without installation
- AS 4912-2002 General conditions of contract for the periodic supply of goods
- AS 4915-2002 Project management — General conditions
- AS 4916-2002 Construction management — General conditions
- AS 4917-2003 Construction management trade contract — General conditions
- AS 4919-2003 General conditions of contract for the provision of asset maintenance and services (Superintendent's version)
- AS 4920-2003 General conditions of contract for the provision of asset maintenance and services (Employer's version)
- AS 4921-2003 General conditions of contract for the provision of asset maintenance and services (Short version)
- AS 4949-2001 Work order
- AS 4950-2006 Form of formal instrument of agreement
- AS 4122-2000 General conditions of engagement of consultants.

Standards Australia has also published a comprehensive "user guide" on AS 4000 to assist users in administering their contracts.<sup>15</sup>

### *Standard contract forms with modifications*

One of the potential drawbacks to the use of standard form contracts is that, because of the variety of interest groups involved in their production, the ultimate form of the terms as published may represent a compromise between conflicting interests which may not be totally acceptable to anyone. The inevitable result is modifications to the standard terms that must be negotiated between the contracting parties prior to entry into the contract. The ambit of such modifications will generally depend on the extent to which the contracting parties are not prepared to accept the allocation of risk provided for in the standard terms. To the extent that each such proposed modification of a standard form contract requires careful assessment of the potential cost and risk by each contracting party, there may be little difference from the process involved in negotiating a bespoke contract. However, provided the cumulative effect of such non-standard terms is not such as to change the entire character of the standard form of contract, the departures from the norm can be readily identified and assessed.<sup>16</sup>

### *Bespoke contracts*

Bespoke contracts for large construction projects are very common in Australia, frequently drawn up by solicitors who are very experienced in construction law and usually acting for the employer. Accordingly, it can be expected that bespoke construction contracts included in tender documents will be more “employer friendly”, and the risk allocation may be significantly different to the standard form construction contracts.

A prudent tenderer faced with a proposed bespoke contract will ensure that the terms are very carefully and thoroughly scrutinised by an experienced construction lawyer to determine the impact of the risk allocation and other contract terms, and to propose acceptable alternatives if necessary. Such a process is invariably expensive, as it requires high calibre legal resources to go through each clause and consider its likely operation in the light of the contract as a whole, existing case law and the usual allocation of risks as between contractor and employer. Even if major issues such as price and timing of a tender are acceptable, the importance of, and time and energy involved in negotiating a substantial number of significant changes to a proposed contract should not be underestimated.<sup>17</sup>

One of the risks of a bespoke contract is that the risk allocation may not be transparent, and the contracting parties may have differing views of how the contract terms operate. In theory this should not occur, as the words of a contract are to be construed in accordance with their plain and ordinary meaning. However, construction contracts usually comprise a number of legal and technical documents that must be construed together as a single instrument, and it is not unknown for this extensive documentation to have inconsistencies or ambiguities. It is submitted that these are more likely to occur in a bespoke contract than a standard form contract because the evolutionary and consultative process of creating a standard form contract involves detailed consideration of their provisions by a number of skilled practitioners with a range of skills and perspectives.

Inevitably, more man-hours are invested in the production of a standard form contract than a bespoke contract, which it is submitted, reduces the likelihood of creating discrepancies or ambiguities.

Hibberd identified the reasons for making amendments to standard forms as being commercial pressures and the desire to change the risk profile: “The dumping and hedging of risk to reflect the commercial muscle of the parties and the emergence of risks becomes all too clear in the tension between the supply and demand sides of the industry.”<sup>18</sup> It is submitted that these are also the reasons for the selection of a bespoke contract in circumstances where, *prime facie*, a standard form contract could be adopted.

In a 1996 paper, Fenn et al reported the results of a significant survey of nearly 2000 uses of Standard Form Contracts and bespoke contracts.<sup>19</sup> This survey found that there were significant differences between some standard contract forms in the perceived expectancy of disputes. One of the standard contract forms found to have a low level of disputes was the NEC suite of contracts, in which transparent allocation and reduction of risk is a stated aim of the drafting. The study also found that bespoke contracts had the highest expectation of disputes, followed closely by a government form.

### **Advantages of standard form contracts**

It is suggested that the advantages of using a standard form contract that aims to be evenhanded as between the contracting parties, in preference to a bespoke contract, may include the following:

- More certainty in the meaning of contract terms, because the way in which standard contract terms operate in practice are widely understood.
- Reduced transaction costs of entering into a contract because of the parties’ familiarity with the contract wording. Tenderers have to spend considerable time and expense in analysing “one-off” contract conditions in bespoke contracts, pricing the increased risks and negotiating acceptable contract conditions. Those transaction costs are likely to be paid by Employers, either through increased tender prices of the contract being bid, or in increased prices for future contracts.
- Reduced tender prices for a widely understood regime of risk allocation and contract administration. Tenderers may put a higher price on the unfamiliar risks in a bespoke contract than they would in respect of the more familiar standard form contracts.
- Reduced contracting costs resulting from familiarity with the form of the contract. Increased project execution costs for the use of a bespoke contract are likely to result from the additional work required by contract administration personnel to train for and administer unfamiliar contract terms.
- Reduced dispute because of familiarity with the risk allocation in a standard form contract. Unfamiliar risks in a bespoke contract may be under priced, leading to an under bid project in which the contractor may endeavour to recover costs in any legitimately arguable way.
- Reduced risk of contractor default — the contract price in a bespoke contract may not adequately provide for the unfamiliar risks the contractor assumes.

- Potentially more bidding competition — some possible bidders may not be prepared to contract on the basis of a bespoke contract perceived to be too one-sided.
- The benefits of precedent — the wide usage of standard form contracts means that over time these are subject to judicial analysis and interpretation as to the meaning of the words used in specific clauses. Such judicial precedents for the meaning of the contract provisions in published case law<sup>20</sup> would normally provide a persuasive precedent for other judges to follow in respect of the same wording. They do not of course constitute legal authority, since every contract must be considered as a whole, and the terms of a standard contract must be construed in relation to their use in the particular circumstances.

The positive impact of judicial consideration of standard contract terms was summed up by Lord Hoffman as follows:

The evolution of standard forms is often the result of interaction between the draftsman and the courts and the efforts of the draftsman cannot be properly understood without reference to the meaning which the judges have given to the language used by his predecessors.<sup>21</sup>

A compelling case for the use of standard form contracts in a more efficient approach to contracting in the oil and gas industry for the UK continental shelf [UKCS] has been made as follows:

Invitations to Tender issued by UKCS operators in the past typically contained individual specific contract terms and conditions. More often than not these terms would differ from the form previously seen by contractors thus necessitating a fresh review on each and every occasion. A variety of contracts, legal and project/operational personnel will typically be involved in this process. The contract form issued by the operator would normally be drafted in the operator's favour, anticipating, and receiving, lengthy qualifications by tenderers. Tenderers in turn would demand more concessions than they would expect the operator to agree to as "negotiation" was expected. Often lengthy discussion followed, involving many individuals, before an agreed position was reached.

The above process, on an industry wide basis, taking into account the number of operators, contractors and suppliers involved in the whole range of exploration, development and production activities covered, has a very significant resource and cost impact.

What does this process achieve? For many who have worked with this arrangement over many years the belief is that it achieved very little. Risk is not managed or allocated where it can most appropriately be borne, rather it is pushed from one party to another depending on prevailing market conditions. Additional insurance costs can result and contract costs may be increased due to uncertainties and/or contingencies being added. Ultimately, however, the contracts that are signed by different operators and contractors often end up being remarkably alike.<sup>22</sup>

## Conclusion

It is noteworthy that the large UK oil and gas industry promotes the economic advantages arising from a standard approach to contracting, whereas the Australian oil and gas and other resource industries still seem to be wedded to the approach of bespoke contracts (generally written on behalf of the employer) with general conditions peculiar to each employer and each project. It is suggested that the use of bespoke contracts in Australia ultimately achieves very little other than adding unnecessary costs and uncertainty to the contracting process.

Any apparent advantage that may appear to be achieved by the use of contracts that alter the traditional "balance" between employer and contractor by transferring risk to the contractor is likely to be illusory, because of higher costs either on the current or future contracts. A rational contractor will increase its tender price by an appropriate contingency sum if it understands that a particular contract requires it to accept risks that it cannot properly manage. An irrational contractor that does not price those risks, or a contractor that does not understand such risks will underprice its tender. This may appear to give an advantage to the employer, but is likely to result in increased disputation under the contract, and higher costs on future similar contracts, arising from the collective understanding of the performance of contracts within the construction industry. In an extreme case, underpricing of risk by a contractor could lead to its insolvency, and consequent termination of the contract before completion, a distinctly unpalatable risk for any employer!



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## Footnotes

1. Max W Abrahamson, "Risk Management" (1983) *International Construction Law Review* 241, 244.
2. "Standard Conditions of Contract" (2001) 4 *BDPS News* 1, 4.
3. <<http://www.consensusdocs.org/about.html>> (25 November 2008).
4. Brian Eggleston, *The New Engineering Contract A Commentary* (1996) 7.
5. Orgalime Turnkey Contract for Industrial Works.
6. International Chamber of Commerce Model Turnkey Contract for Major Projects (2007) <<http://www.iccbooks.com/Product/ProductInfo.aspx?id=488>> (25 November 2008).
7. <[http://www.bimco.org/Corporate%20Area/About/BIMCO\\_a\\_century\\_of\\_service.aspx](http://www.bimco.org/Corporate%20Area/About/BIMCO_a_century_of_service.aspx)> (25 November 2008).