Integrated Practice: Legal Relationships

Charles Thomsen FAIA, FCMAA
charlesthomsen@charlesthomsen.com

Table of Contents

Integrated Practice: Legal Relationships

How do you make multiple companies work like one?
…Bruce D'Agostino, President, CMAA

The IPD premise is that design and construction will improve if the designers and constructors align their interests and remove legal barriers to collaboration. And so, as an IPD project begins thoughts turn to legal structures to support this hypothesis.

If a single company executes a project, and if there is a problem, one part of the company doesn't sue the other. Their financial interest is one and the same and they find it easier to access material or intellectual resources from within the company than to contract for them with another company.

Although a profit center in a company may be inclined to make self-serving decisions and although a person in one part of the company might get cross at another, employees of a single company are more closely aligned than employees of independent companies working under separate contracts for the same project. When conflict surfaces within a company, an executive is likely to step in and align the team without the cost and delay of litigation.

So in organizing an IPD team, a common intention is to simulate the collaborative and litigation-free characteristics of a single company.

(See comments in the chapter on Organization, Operating Structure and Commercial Terms.)

Of course, it can't be done completely. As long as multiple organizations have interests in the IPD Team and those organizations are doing at least some of the work independently, unaligned self-interest will exist. There will never be a contractual vehicle that will replace the need for professionals who have their hearts in the right place. But gains can be made.

Partnering: Prelude to IPD

Traditionally, a project is created by an ad hoc assembly of many specialized organizations, each operating with its own prejudices and self-interest. Each works on its own turf: economically, legally and culturally.

Collaboration is hardly a new idea. In 1427, when Brunelleschi was constructing the Cathedral in Florence, tensions became so great among the artisans that they were made to take an oath to "forgive injuries, lay down all hatred, entirely free themselves of any faction and bias, and to attend only to the good and the honor and the greatness of the Republic , forgetting all offences…"

Such a clause might be useful in an IPD contract.

Our management practices have viewed organizational authority, precise contracts, detailed schedules and legal recourse for non-performance as the appropriate tools for knitting together such ad hoc organizations. The theory is that if each does its work satisfactorily, as specified and scheduled, the result will be OK.

It's logical but often disappointing. The problem is that we live in an imperfect world with unpredictable events. And everyone makes mistakes. To often, the result is conflict and legal action. Legal action ricochets. If one party sues another, the defense is to find the plaintiff's mistakes and counter sue. The conflict spreads from there. Since everyone has made mistakes, everyone is open to blame.

During the 1980s, many leaders in the construction industry began to add management philosophies that invoked the soft but essential spirit of collaboration. They recognized that if people on a project team want to help one another, they would help the project.

Partnering emerged—a process that focuses on building a team, opening channels of communication, installing systems to anticipate and resolve problems and defining project goals for those who must work together. Partnering works. It *does* improve collaboration.

But when problems come up, there are no contractual teeth preventing the partners from getting a divorce. So IPD is a logical evolution—a means to add contractual structures to the spirit of Partnering.

Dealing with Disputes

A concept in the early Alliancing projects was for each member of the Core Team to agree to not sue other members of the team (often

with a list of exceptions for such acts as willful misconduct or egregious mischief).

Joe Horlen, a lawyer and head of the Construction Science Department at Texas A&M, questions the practical application of that concept. He says, "Although it may be theoretically possible in some jurisdictions, it would likely be no more than a paper tiger if the project fell apart--which is the reason to have a contract in the first place.'

'It would be hard to find a trial court judge who would dismiss a case and limit a party's access to the trial even if they signed a contract to that effect. Access to courts is in the constitution and is taken very seriously by the law, and to waive such access is difficult. Unequal bargaining positions, vague language and many other arguments tend to cause courts to set aside such agreements."

Such a clause in not only questionable in its enforceability, it's a questionable concept. Clearly, many company shareholders would be circumspect about signing away their access to litigation.

However, litigation is expensive, juries don't understand construction and the courts are slow: construction projects can't be put on hold for a few years while a dispute is settled. Usually it just doesn't make sense to take a dispute to court. What does make sense is to develop efficient ways to deal with disputes quickly, and fairly with people who understand the process.

Joel Darrington,[1] a lawyer with McDonough Holland & Allen PC who specializes in construction matters, point out, "For this reason and others, many IPD projects use dispute resolution processes. They start with the management committee. If they can't resolve the dispute, it may go to a group of senior executives from each of the disputants.

From there, disputes may escalate to a third-party neutral for investigation and recommendations, mediation or both. Mediation could be binding or non-binding. If non-binding, then arbitration or litigation would be the forum of last resort to resolve the problems. Anecdotally, very few IPD projects (if any) make it to litigation between the parties, even if technically allowed under the contract."

Choices

The IPD Core Team is assembled from the key organizations that share the risk and reward of executing a project (or a program). It can

[1] Joe made many helpful additions and changes to this paper.

be two organizations (an AE and a CM), or it could include subconsultants and subcontractors. Normally, the Core Team will be limited to organizations that have a significant role in shaping the project outcomes.

At the start of an IPD project, the owner and the Core Team must agree on a legal structure for the Core Team. The technical considerations to ponder are those of liability, taxes, legal authority and administrative cost.

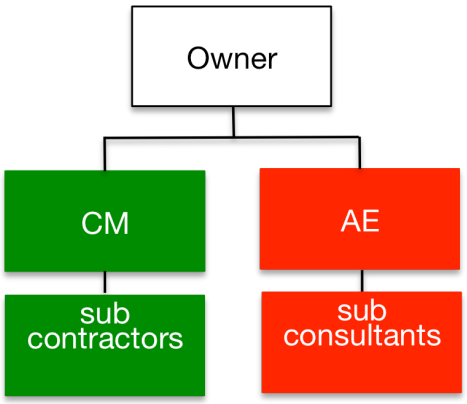
However, an overarching consideration is the effect of the legal structure on the team's culture. The salient question is: what form of legal entity maximizes collaboration and will work for the specifics of the project and the constraints of the owner? (Clearly, public, institutional and private organizations will present vast differences in procurement regulations.)

The common choices the Core Team may consider are:

1. Multiple independent contracts (the traditional approach)
2. A single multi-party contract
3. A joint venture (a JV)
4. A limited liability company (an LLC)

Multiple Independent Contracts

An owner could choose a traditional approach, contracting with designers and builders independently but still use some of the aspects of IPD.



The traditional approach is for the CM and the AE to have independent contracts with the owner. In itself, it does not contribute to Integration, but commercial terms can be added to the contracts to enhance collaboration.

Liability

Unless limitations or transfers of liability are put in the contract, each company is liable for its own work and the responsibility is compartmentalized in its own silo of contractual risk and responsibility. Again, as noted above, there also may be clauses (with untested enforceability) that each of the companies sign to limit their ability to sue one another—but dispute resolution provisions can be put in place.

Taxes

Each company pays its own taxes using its own accounting policies.

Administrative Cost

Each member manages its own company operations with its existing overhead staff, policies, systems and insurance. Since there is no

overarching organization binding the team together, there is no additional administrative cost.

Culture

This multiple-contract structure does not contribute to an IPD culture. However, an owner could establish commercial terms to promote integration such as a shared incentive pool for meeting project goals that would be earned or lost, multi-laterally, by the team.

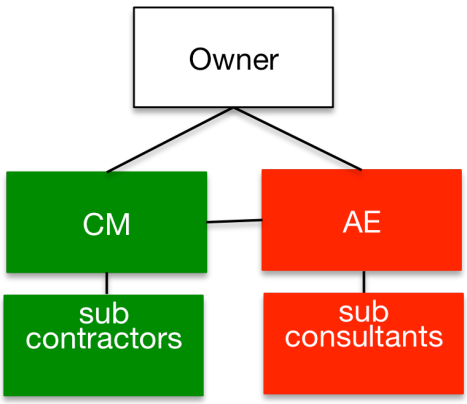
Or in the case of government contracts that allow award fees but prevent shared award pools among impendent contractors, the criteria for the award for each contractor could be the same. (A common divisive arrangement is having team members who are rewarded for different goals. Perhaps the most effective part of an incentive pool is that it carries a clear statement of goals and a message from the owner that collaboration is expected and rewarded.)

There could be participation in executive committee governance, team meetings ("sustainable partnering") to review everyone's performance, or other aspects of integrated project organization, as long as each of the contracts was coordinated on these points and the parties agreed. One strategy is to have separate contracts that each reference a common set of project terms and conditions that would help minimize inconsistencies between the contracts.

Single Multi-party Contract

Another possibility is a single, multi-party contract signed by each member of the Core Team (including the owner).

Unlike a traditional contract that only defines responsibilities to the owner, the multi-party contract also defines the duties of each party to one another. The owner pays each party individually. The payment terms could be lump-sum or cost-plus, and there could be a target price or GMP for each. Often, there is a shared incentive plan. See our fuller discussion in the chapter on Organization, Operating System, and Commercial Terms.



A multi-party contract is signed by each member of the Core Team and defines responsibilities to one another.

Liability

In such a multi-party agreement, it is possible to define and stipulate the responsibilities and liabilities of each party within the context of an integrated team defining liability to the owner.

Some argue that by jointly signing an agreement that provides for pursuing a common project with some shared responsibilities and liabilities, the parties are forming a joint venture and would result in the team members being held jointly liable to a third party. In the spirit of shared responsibility so prevalent in IPD, it is likely that there would be much in the language of the agreements and the actions of the parties to support such an allegation. The debate has not been resolved, and so far no cases have addressed this issue.

Taxes

Each party will pay its own taxes based on its income and following its standard accounting policies.

Administrative Cost

A multi-party contract is likely to be an efficient choice. Each member will manage its operations with its existing overhead staff, policies, systems and insurance. There must be a management committee to coordinate the project and adjust the duties and compensation as the project unfolds. The owner, as a signatory of the multi-party contract, would participate as a member.

Culture

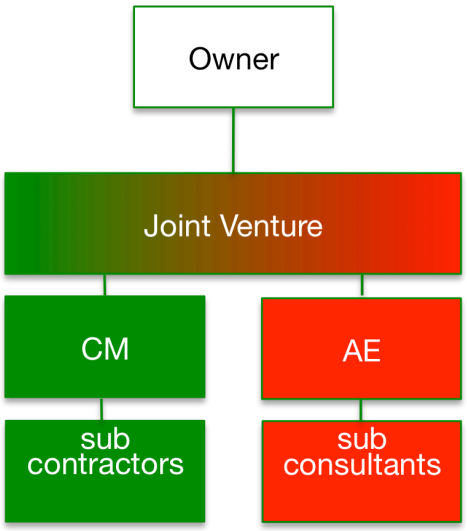
Some IPD advocates would argue that such an arrangement does not go far enough to remove the independent silos of risk and responsibility and that a legal structure that provides a more cohesive organization would be more "integrated."

While there is a unifying management committee and typically a unifying incentive pool that adds to the collaborative culture, the independent silos walls of responsibility remain intact.

The counter argument is that any organization, short of an independent, fully staffed multi-disciplinary single company, will have independent silos. Even when companies form project-specific entities and become owners, they typically subcontract design and construction management to member companies—again creating silos.

Joint Venture

"Joint venture" is a broad term with shaded nuances in different industries. In the construction industry a JV normally implies a partnership between two or more organizations that combine their resources to do a specific project or program. Normally, there are two contracts. The JV has a contract with the owner that spells out its duties and responsibilities. And the members of the JV have an agreement among themselves that spells out their individual duties and responsibilities to the JV. The owner pays the JV for the work. The JV pays the members—after deducting JV costs (if any). Normally, the terms of payment to the members of the JV should reflect terms of payment from the owner to the JV. (For instance, if the owner-JV agreement is cost-plus, the JV can pay the members on a cost-plus basis. If the owner-JV agreement has a GMP or target price provision, the individual members of the JV should probably have GMPs or target prices in their JV agreement with the JV.).



A typical joint venture is uncommon for IPD projects because the CMs don't want responsibility for the AEs design and the AEs don't want responsibility for construction. However, the CM and the AE can contract with a JV with indemnities and GMPs for their respective work and pass savings to the JV. The JV can hold the profit, contingencies and incentive fees and pass it to the AE and CM based on a predetermined agreement. That encourages collaboration.

Liability

Normally there is "joint and several" responsibility stipulating that each member of the JV is responsible to the owner for the entire work. If one party defaults, the remaining partners must assume its responsibilities. Consequently, the total assets of each member are on the line for the successful execution of the agreement.

For this reason, JVs between AEs and CMs are seldom used for either IPD arrangements or design-build: architects don't want responsibility for construction and contractors don't want responsibility for design.

However, a unique approach is for a JV to perform none of the work but subcontract design work to the AE and construction work to the CM. Each indemnifies the other. Each works at cost and provide a GMP for their respective responsibilities to the JV. If work is done for less that the GMP, the savings accrue to the JV.

The JV provides management and executive activities and holds the profit, contingencies and incentive fees to be distributed at a predetermined rate. Now, if the AE can think of ways to help the contractor, it improves the profit, contingency or award pool—and vice versa—certainly in the spirit of IPD.

Most owners would not agree to contract with a JV that had no assets, so if the approach in the paragraph above was used, it's likely that the owner would require corporate guarantees. However, the AE could guarantee the typical AE responsibility and the CM could

guarantee the typical construction responsibility to the JV and indemnify one another. Of course such indemnities are worth no more that the assets and insurance of the respective companies.

Taxes

For tax purposes, a JV is seen as a partnership between companies. In a partnership, income flows through the partnership to the partners and the partners are taxed as individuals. Although in many states a JV must file a tax return, profits are normally passed through to JV partners and the JV has zero income. Even if the JV held the profits, they would be distributed to the JV partners. The members of the JV would then file their own tax returns based on their usual accounting policies.

Administrative Cost

Although it is possible to distribute all the expenses of the JV to each of the member companies, a JV typically develops a little overhead cost of its own for accounting, entertainment, legal representation, perhaps office space and supplies, etc. So there is usually a minor increase in overhead. It is rare for a JV in the construction industry to have its own employees and create its own overhead staff, policies and management systems, but it is sometimes done.

A JV must have a management committee to direct the organization, make major project decisions, modify the duties, adjust the compensation or handle other administrative or operational decisions as the project unfolds. And the JV may invite the owner to participate as an ex officio member. However, the JV management committee is not the same as the project executive committee that involves the owner as a integral member—that would still be an important part of the project governance.

Culture

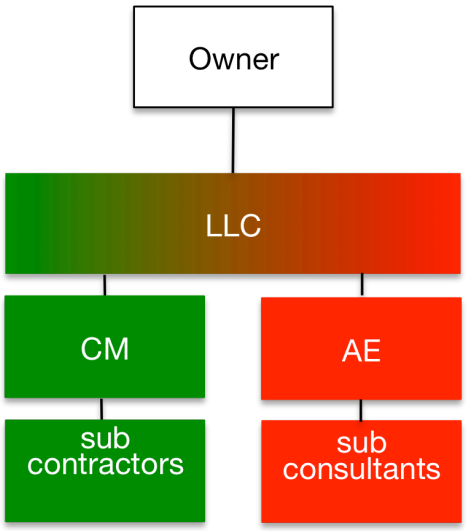
Some IPD advocates would feel that while the "joint and several" responsibility exposes the members to inclusive liability for the entire project, it benefits the project because the members share inclusive responsibility for the result. Collaboration is likely to improve when each partner is responsible for the work of the others.

It's also possible for the JV to develop an integrated team, staffed with employees of the JV member companies, to manage a PMIS and a BIM model. While the AE would sign a sub-set of the drawings for permits, the JV could own the model and assume responsibility for

the integrated set—one way to ease some of the concerns that exist with PMIS and BIM integration when there are separate contracts.

Limited Liability Company

Another possibility would be for the Core Team to form a Limited Liability Company ("LLC") to build the project.[2] The ownership of the LLC may be distributed to the IPD Core Team proportionate to the level of effort and cost of the services that each member of the IPD Core Team might provide—and therefore proportionate to the potential profit (or loss) of members. Or it could be distributed some other way, perhaps based on the party's ability to influence project outcome or the amount of risk assumed by a party.



An LLC theoritically limits the liability of its members, however a well informed client will require coroporate guarantees. The LLC may limit third party liability.

The members would agree to divide the work and subcontract it among themselves. The AEs design, the consultants consult, the CMs manage and the constructors construct. Each prime company is reimbursed for their work at cost or in according to any reasonable predetermined arrangement. At the end of the project, the profits are distributed based on the division of ownership. Non-Core Team members would be contracted either directly to the LLC or subcontracted to prime companies.

Liability

If architects, engineers and constructors form an LLC to execute a project, their liability to the owner is limited. That may be in their interest but not in the interest of the owner. Unless the situation is exceptional, a well-informed owner would require corporate guarantees.

While owners of an LLC enjoy limited liability for most of their business transactions, the protection is not absolute. State statutes differ, but an owner (either an individual or a company) can be held personally liable if she, he or it injures someone, guarantees a bank loan or a business debt, fails to manage employee withholding taxes properly, is intentionally fraudulent, illegal, or reckless or treats the LLC as an extension of his, her or its affairs.

This last exception requires attention. If owners don't treat the company as a separate business, a court might decide that the LLC

[2] C Corporations, S Corporations, LLPs and LLCs allow the owners to limit their liability to the extent of their investment. However, the members of an IPD Core Team are apt to be companies, not individuals. That excludes LLPs and S Corporations. The C Corporation has a double layer of taxation so that is a discouraging characteristic. That leaves the common choice to be an LLC.

doesn't really exist, and the owners are doing business individually and are therefore liable for their acts.

Taxes

The profits of the LLC are passed through to the members. In the context of this paper, the LLC members would be the members of the IPD Core Team. They could distribute shares any way they agreed to, but one likely approach would be to distribute shares proportionate to their potential risk and economic interests (e.g., their overhead and profit, or their fee) in the project.

Administrative Cost

An LLC will require a full set of administrative resources: legal, accounting, human resources, etc., although it's possible for one of the IPD Core Team companies to do these jobs. Nevertheless, there will be additional cost. Significant set-up costs are involved.

The LLC will need to carry its own property and liability insurance. Even though the LLC shields the member companies from liabilities, it must stay in business to execute the project and for some time afterward.

Culture

Many believe that the culture of a single company provides the best integration. That might work if the project is large enough to warrant a full-time staff. That, of course, helps approach the single company ethos, but it takes time and money to create the administrative systems and bureaucracy, and many employees will be hesitant to leave the ladders of their own organization's advancement programs. Such an approach would be easier for a construction team that might require a full-time project manager, superintendent and field staff for several years. But the design function typically has more specialized talents that move in and out of the project for shorter assignments.

However, in most IPD projects, the more practical approach will be to simply subcontract the required tasks of management, design, construction and administration to member companies. The IPD Core Team could contract with the subconsultants and subcontractors, or the individual organizations could contract with the appropriate subconsultants and subcontractors. That approach would allow the existing accounting and contracting staff in the key organizations to do the administrative work.

The LLC would have two unifying characteristics. Shared responsibility to and with the owner and shared profits/losses would

be the basic elements that motivate alignment of the IPD Core Team. Those same characteristics can exist in any legal structure if put together appropriately.

So there is much to debate about the value of an LLC for an IPD Core Team. Traditionally, owners don't want their service providers to have limited liability. They will want the companies they choose to have their skin in the game with personal or corporate guarantees—negating much of the value of limited liability.

The limitation of liability might still be of some value in a suit instigated by a third party (a slip-and-fall suit, for instance) but the injured party, in spite of a lack of privity, might be able to litigate against the architect or other team members anyway.

Most states have extensive regulations covering the bylaws and governance of a corporation that may limit the freedom of the IPD Team members to set up unique management procedures. The participants in other contract structures have broader opportunities to invent their own rules of governance and operation.

A Bit of History

Since much of the thought process surrounding the legal relationships hinges on liability, it seems useful to look at the history of change so we might understand where we are, connect the dots and think about the future.

From the middle of the 19th century to the middle of the 20th, there was little change in the legal structures of design and construction. The task was simpler. But industrialization and specialization in the industry have brought the need to involve far more organizations in a collaborative endeavor for a far more sophisticated product. Consequently, recent decades have seen innovation by construction professionals and their lawyers. By the time this paper is read it will be incomplete—someone will have invented another approach.

The growth of limited liability organizations

In the 18th century, the concept of an organization that limited investor liability didn't exist. An investor in an enterprise was a partner and personally liable.

But industrialization in the 19th century brought the need for capital. Economic growth required companies to attract funds. It was clear that to accomplish that, it would be necessary to limit the liability of investors to the extent of their investment. The concept of a limited

liability corporation emerged and flourished and has taken multiple forms.

However, the philosophy of limited liability didn't immediately apply to professionals (architects, engineers, lawyers, doctors). For most of the 20th century, state statutes required professionals to be liable for their work as individuals and precluded them from practicing as a limited liability company. That changed in the last half of the 20th century, and a number of limited liability concepts emerged in the statutes.

C Corporations

Until the late 20th century the C Corporation was the only form of a limited liability company. The C Corporation is a business entity that limits the liability of the shareholders to the amount of their investment. The number of shareholders is unlimited. Other companies can be shareholders so there can be holding companies and tiers of subsidiaries. C Corporations can be private, controlling the number and selection of owners and the value of their shares, or they can be public with their ownership and the share value controlled by the market.

The C Corporation is an entity and must pay income taxes on its profits. The owners pay individual income tax only on money they receive from the corporation as salary, bonuses or dividends. The shareholders are then taxed for the income produced by the dividends. Although C Corporations are taxed at lower rates than individuals, this double tier of tax will usually take a larger bite out of the shareholder's eventual after-tax rewards from the enterprise than most other forms of business organization. (That may depend on the current tax laws and the tax brackets of the shareholders, and while usually the case, there may be exceptions.)

Some C Corporations routinely bonus all of their profits to owners, using debt to capitalize the business, thus avoiding taxes on profits. It is a practice that may be examined by the IRS.

S Corporations

Frustrated by the double tier of taxation, businessmen and professionals persuaded lawmakers that there should be a form of corporation that limited the liability of its investors but avoided taxation cost of the C Corporation. S Corporations are regular corporations that have elected S Corporation tax status. An S Corporation lets the shareholders enjoy the limited liability of a C

Corporation but pay income taxes on their personal returns as a sole proprietor or a partner.

The profits of an S Corporation are distributed to the shareholders as cash and/or increased share value, and the shareholders are taxed on the sum of both at ordinary income rates. (If the shareholders leave the money in the company to capitalize operations, increasing share value, it is still considered personal income and taxed.)

Most states follow the federal lead when taxing S Corporations by taxing the business's profits on the shareholders' personal tax returns. However, a few states tax an S Corporation like a regular corporation.

S Corporations impose some limitations. Shareholders must be individuals (not a company) and a U.S. citizen or resident. There may not be more than 100 shareholders. An S Corporation shareholder may not deduct corporate losses that exceed his or her "basis" in corporate stock.

Limited Liability Partnership (LLP)

And then, after creating an S Corporation that was taxed like a partnership, some states created a partnership that had the limited liability of a corporation. The Limited Liability Partnership was created primarily for professionals like lawyers, architects and doctors. It is a partnership, but one that limits the liability of the partners to their current equity participation in the partnership.

Limited Liability Company (LLC)

Not long ago, an S Corporation was the only limited liability organization that did not have the double layer of taxation. But in the late 20th century, adding LLCs expanded the choice. A Limited Liability Company is like a C Corporation in that it limits the liability of its owners, but like an S Corporation, it can pass income through to shareholders. (However, an LLC may also elect to pay taxes like a C Corporation.)

❖ ❖ ❖

Designing a legal structure for project delivery is about juggling primary considerations of responsibility, risk and collaboration with a secondary tier of considerations: taxation, administrative cost and public liability. It is influenced by significant variations in state laws and case law governing licensing, codes and the formation and operation of legal entities such as those discussed above.

And so a word of caution is appropriate at this point. This document is not a do-it-yourself legal guide. Departures from common practice require examination by experienced construction lawyers conversant with the details of applicable state laws.

What is encouraging is that AEs, CMs and their lawyers are turning away from contracts that focus only on defining and delegating compartmentalized risk and responsibility to an owner. Recognizing that many organizations must work together to produce the project, the focus is on finding on finding productive ways to share risks and rewards and build collaboration. That will make a better game for us all.