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Incomplete Contract in Private Finance Initiative (PFI) contracts: causes, implications and strategies

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Abstract

An incomplete contract is a contract that fails to state all the parties' rights and obligations, has gaps, missing provisions, and ambiguities in its terms and conditions. In theory, a complete contracts cannot be achieved, and many contracts inevitably remained incomplete. This phenomenon also applies to Private Finance Initiative (PFI) contracts. Human factors play an important role in determining the completeness of a contract. In the context of PFI contracts, this paper presents a critical review of incomplete contract, its causes, implications, and strategies.

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Keywords: construction; incomplete contract; Public-Private Partnership (PPP); Private Finance Initiative (PFI)

1. Introduction

Most economic activities involve contracts to be made. Contracts serve as an important platform to ensure that future planning of transactions and all potential contingencies, responsibilities, and risks are properly specified. Past studies in relation to contracts suggested that contracts can either be complete or incomplete. It must be noted that a

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contract can also be categorized according to the settings of contract formation, the substance of the contract and the likes. However, in this paper, the classification of a contract by Walker (2012) and Athias & Saussier (2010) is adopted because this paper concerns the substance of the contract i.e. whether it is incomplete or otherwise.

A complete contract is defined as a contract that specify the rights and obligations of each party for every future state of the world (Scott & Triantis, 2005). In other words, a complete contract will never need alteration, renegotiate or additional agreement, and there is no room for adverse selection or moral hazard (Saussier, 2000).

Whereas, a contract is said to be incomplete when it fails to spell out ex-ante the parties' requirements, duties and obligations for every realized contingency (Fraja, 2002) and it has gaps, missing provisions, and ambiguities in its terms (Hart, 1995). Past studies discussed the reason of incomplete contract include long-duration project, high risk or uncertainty, high transaction cost, bounded rationality, asymmetric information and signalling a trust. Although it seems that an incomplete contract is unavoidable, what needs to be noted is the implication that it brought to the success of a project. Literature review reveals that an incomplete contract could give positive and negative implication to the success of the project. While the positive implication is obviously good for the project, attention should be given to minimizing or eliminate the negative implication of incomplete contracts.

In theory, complete contracts cannot be achieved and many contracts, including contracts for Private Finance Initiative (PFI), remained inefficiently incomplete. PFI is an alternative procurement strategy that had been introduced to undertake the development of public infrastructure and services, which previously it were the public sector's responsibility (Khairuddin, 2009). According to United Kingdom model, PFI forms a subset under Public-Private Partnership umbrella (Khairuddin, 2009). In PFI, the public sector will specify the required output and purchase the services provided by the private sector. On the other hand, the private sector will be responsible to finance, design, construct, manage, operate and maintain the project until the end of the concession period.

This paper aims to present a review of incomplete contract focusing on its causes, implications, and strategies, with reference to PFI contracts. The review is conducted through an extensive literature review. The paper proceeds as follows. First, a review regarding the concept of contract is presented. Second, followed by discussions on the incomplete contract in PFI contracts and standard contracts. Third, the cause of incomplete contract is explained. Fourth, followed by the implication of incomplete contract. Finally, strategies to deal with the incomplete contract are presented. The final part of the paper is the concluding remark.

2. The concept of contract

In general, a contract can be categorized into a complete and an incomplete contract. A complete contract is designed under the assumption of zero transaction costs (Solum, 2012) and symmetric information (Athias & Saussier, 2010). The terms of the contract should cover for every contingency, which means that it is free from gaps. Past studies argued that there is no possibility of adverse selection, moral hazard or even disputes in a complete contract because any potential source of dispute has already been identified (Athias & Saussier, 2010; Hart, 1995). However, a complete contract is difficult to achieve because parties always face with uncertainties which consequently requires parties to renegotiate, breach or litigate (Iossa, Spagnolo, & Vellez, 2007; Hart, 1995). Since the world itself is complex, it somehow affects the contracting parties to achieve bargains or complete contracts (Kostritsky, 2004). Craswell (1999) contended that a complete contract is only an imaginary concept use by people to define one endpoint of completeness.

The incomplete contract is the opposite of complete contract. Kostritsky (2004) stated that most contracts are incomplete to some degree. Due to the incompleteness of contract, the contracting parties are exposed to the risk of having disputes, moral hazard or adverse selection (Iossa et al., 2007). Findings from Nur Syaimasyaza & Khairuddin (2014) found four characteristics of incomplete contract, and they are presented in Table 1.

Table 1.Characteristic of incomplete contract

No.	Characteristic	Description
1	The contract has gaps or loophole (Gurcaylilar-Yenidogan,	The following circumstances explain the gap or loophole in the contract: i. The contract has missing provision or complete absence of certain specification; ii. The contract did not specify who has the right to decide or the decision

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