

# How can we avoid costly disputes?

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Liability costs, the direct costs of commercial claims resolved through litigation, can be estimated at approximately \$870 billion globally of which the liability costs in the United States alone are \$306 billion, according to [a report](#) on International Comparisons of Litigation Costs published by the US Chamber of Commerce in 2013. The US was the largest country in the legal services market in 2016, accounting for about 45% of the global market.

Generally, the total costs of disputes can paralyse capital projects and hinder the ability of companies delivering those projects to compete and prosper. The direct costs highlighted above are only the tip of the iceberg since additional direct costs include expert fees, document preparation costs and investigator fees, as well as costs to the legal system largely swallowed by the taxpayer. More important, litigation imposes significant indirect costs, such as increased borrowing cost, waste of time and resources as well as organizational stress and deterioration of business relationships, which is commonly priced at a multiple of direct costs reaching trillions of dollars a year globally.

Here, we will shed light on the undesirable consequences of commercial disputes, with the focus on disputes arising in capital projects; identify the key root causes and contributors to those disputes; and propose an effective mitigation strategy to resolve disputes amicably or – even better – avoid them early on.

### What are the damaging consequences of disputes?

The key negative consequences of commercial disputes include the overall distraction from the capital project's operation that subsequently damage the project schedule, cost and quality. Disputes leading to design changes or cut-backs during execution hinder the output capacity or level of service of the asset and might increase the total cost of ownership of the asset by transferring construction cuts into higher operation and maintenance (O&M) costs. In addition, disputes tend to hinder or distort effective business decision-making by occupying management time and tying up key management resources. Furthermore, conflict-related personal and organizational stress often leads to anxiety and an unhealthy work environment. Any conflict triggers a reactivity cycle. An adversarial process greatly intensifies that cycle, with the result that perceptions and positions are driven further apart. Consequently, capital projects suffer.

In case of conflict, additional staff will quickly be necessary to respond to an increasing imbalance between core skills required to manage output delivery versus those skills required to manage claims and disputes. Generally, we observe a progressive deterioration of stakeholder relationships combined with a substantial decrease of overall level of trust leading to ineffective communication

*Your opinion is important: The World Economic Forum would like to understand better how the future of dispute prevention and resolution could look like. **This survey** should only take a small coffee break to be completed.*

and collaboration between project stakeholders. In the long term, increased borrowing costs will affect companies' capabilities to create jobs as well as to reinvest and grow. On a macro-economic scale, uncertainty created by the aggregate of all disputes in an economy can increase the overall financial risk, which, in turn, might make capital project investment in high-dispute-risk jurisdictions less attractive for investors.

All these consequences increase the level of distrust and the transactional cost of such highly valued and economically critical projects. And in large projects, the magnitude of the financial consequences from failing to meet contractual commitment and obligations can lead to bankruptcy of critical local entities and of the companies engaged in the implementation of the project.

### Why do disputes occur?

There are many ways to categorize root causes, proximate causes and contributors that lead to conflict on capital projects. The fundamental factors that drive the evolution of project disputes are uncertainty due to project complexity, contractual complications often amplified the more multilayered the project stakeholder ecosystem, and behavioural factors often anchored by unrealistic expectations or political constraints. While we certainly should implement measures to reduce the occasion for disputes, we must also accept the reality that conflicts on major capital projects are inevitable. There are simply too many stakeholders with less than perfectly congruent interests and agendas. What is not inevitable is protracted fighting in response to conflicts. Here, we would like to demonstrate how contracting practices, project management practices as well as political and external factors can lead to conflict.

### Contracting practices

Unbalanced or unclear risk allocation inevitably can lead to an infinite expansion of contractual liabilities towards the contracting party, inducing a significantly higher probability to breach obligations with the potential of subsequent disputes. An insensible, imbalanced and solitary risk shedding instead of a risk-sharing approach between the contractor and the project owner will, therefore, lead to higher overall total capital project costs with the utmost likelihood of conflict. Shortsighted project owners often ignore the most beneficial distribution of risks, which is to allocate each risk to the party that is best able to manage, mitigate or diversify it. Even uncontrollable external risks of loss and damage, such as force majeure, which cannot be attributed to any of the parties and which are not insurable, often don't reside with the party that has the higher long-term interest in the project, typically the project owner. Unfair and inappropriate risk allocation and its intrinsic incapacity to properly assess the cost of the risk always lead to unrealistic tender pricing due to higher price uncertainty and intrinsic risk premiums.

In the absence of a contractually mandated alternative, conflicts may degenerate into adversarial processes. Their intensified reactivity typically surfaces in a *Hegelian* clash consisting of thesis, antithesis and synthesis. When the desired outcome is a third-party decision, threshing out factual and legal issues on which an award or verdict must be based can serve a useful purpose. But the timeframe, investment or diversion of resources and collateral damage of turning a project into a battlefield render such processes dysfunctional as a way of resolving conflicts on capital projects.

Furthermore, an inappropriate contract type, as well as errors or omissions in the contract documents, can also lead to conflict. Each contract type and its associated delivery model – e.g. design-bid-build, design-build, or design-build-operate-maintain, etc. – influence how the project will be delivered. There is no such thing as one-size-fits-all. Public procurement normally relies on existing practices that do not always fit the purpose, which, in turn, could lead to unnecessary conflicts. In particular, this is the case if the final use of the asset and the maturity of the project definition – such as the level of detail of design, the client's requirements as well as the documentation to understand the project and design the contract – has not been taken into account accordingly. Similarly, the lack of alignment of the party's needs and interests and the absence of a robust contractual incentive framework can lead to imminent conflict of interest during the project execution.

### **Management practices**

Increasingly, larger capital projects combined with a lack of trust between the parties inevitably lead to more complex contracts. When necessary skills and expertise are not on-site, inadequate contract administration and ineffective change management practices can soon lead to substantial difficulties in understanding and anticipating the contractual consequences of conflicts. A complex stakeholder ecosystem exposed to ineffective management, supervision and coordination combined with lacking skills and authority issues will be unable to translate complex contractual requirements into effective project controls capable of monitoring quality, scope, schedule and cost. The lack of competence and professionalism of project stakeholders often leads to reactive or even non-existent risk management and lack of anticipation. As a result, lack of clarity, arising conflicts of interest, ineffective deployment of resources as well as power struggles can create an increasingly adversarial culture leading to destructive conflict. As a consequence, an effective conflict management process needs to transform tension into constructive dialogue.

### **Communication issues**

One of the key contributors to disputes during project execution is poor communication – or even communication failure – among project stakeholders. The parties to international contracts do not always share the same contractual and technical culture or the same language and used to work with their own contractual documents and their own local or national best-practice guides. At the signature of the contract, the contractor take over most of the risks as he signed a contractual obligation to

execute a work and to reach a result, in respecting the “rules of the game” as they are defined in the contractual framework. This transfer of risks must be operated in the best possible conditions of communication so that the project owner can be sure that his intentions are clearly understood by the contractor and that the contractor receive all necessary information to transform the objectives of the project owner into a concrete result. In this respect balanced conditions of contract represent in fact a valuable tool of communication, where a common language, common definitions and common procedures are to be used between the parties to the contract.

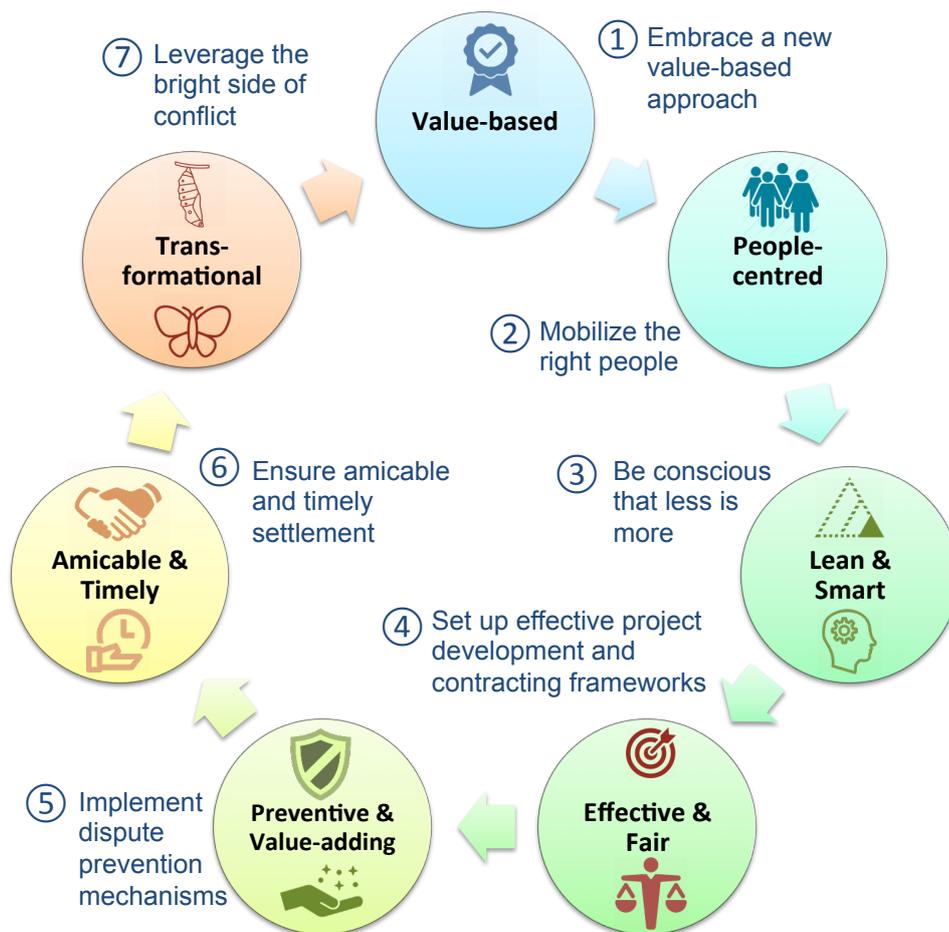
As a successful project is the result of a satisfactory but complex communication process between the parties, the challenge for them is to create the best possible conditions of communication. In particular, the selection of the appropriate form of contract in order to ensure the right implementation of the contract and to focus on the priorities instead of losing time with contractual problems coming from non-understandable documents or with the interpretation of ambiguous conditions of contract is a key factor for an efficient communication.

Moreover, during the implementation of the contract, the quality of a true and efficient communication between the parties, based on clearly recognized and systematic principles will for sure play an essential role in the smooth development of the contract and will increase the probability to prevent and to avoid possible disputes.

### **Political and external factors**

Optimism bias and strategic misrepresentation in planning capital projects lead to inaccurate projections of project costs and asset-user demand. Related impacts such as unrealistic time and quality targets are frequently set by the project owner to meet certain political constraints and ambitions. Consultation with the public can lead to unrealistic expectations if the project is an element of a political agenda and changes to the original plan are often dependent on the election cycle. During project execution, project owners occasionally lack critical project information for educated decision-making due to the inherent information asymmetry in the construction phase. Project owners rarely are able to properly match the project organization with skilled resources to ensure proper project governance. A proximate cause, as a result, can be the lack of necessary decisiveness and responsiveness during the project's lifecycle.

Figure 1: Conceptual framework for effective mitigation strategies to manage conflict on capital project



Alternative dispute resolution, a set of practices and techniques aimed at permitting the resolution of legal disputes outside the courts, can reduce transaction costs since it is cheaper and faster than ordinary judicial proceedings; it can create resolutions that are better suited to the parties' underlying interests and needs; and it can improve ex-post compliance with the terms of the resolution. I think that alternative dispute resolution techniques hold great promise for both the avoidance of disputes in the construction industry and for their prompt and fair resolution.



Robert H. Mnookin, Williston Professor of Law; Director, Harvard Negotiation Research Project; Chair, Program on Negotiation, Harvard Law School, Cambridge, USA

### How can we mitigate disputes effectively? A conceptual framework

The following conceptual framework introduces effective mitigation strategies to better manage conflict on capital projects and to be in a position to identify disputes early to resolve or avoid them altogether.

- 1) Embrace a new value-based approach.** Good faith, mutual trust and highly ethical conduct have to be at the centre of each capital project. This requires a shift towards a value-adding approach. It entails a new culture, new mentalities, new visions, new methods and possibly new expertise, including neutral voices that can add value and objectivity to the discussion, such as a truly independent certifier and dispute resolution boards, and entities that speed up processes with a proactive dynamic within the infrastructure development ecosystem (e.g., Infrastructure Development Agencies in Australia). A practical application is the use of a "value for money" evaluation to select the best delivery framework.

A change in negotiating culture is required which focuses on the needs and interests and encourages a larger cake instead of dividing it up by applying interest-based negotiation and non-violent communication principles. A good starting point is [to commit to required resources](#), to be able to successfully manage and resolve disputes through negotiation, mediation and other alternative dispute resolution processes when appropriate, with a view to establishing and practicing global, sustainable dispute management and resolution processes.

- 2) **Mobilize the right people** by targeting the right expertise as well as hard and soft skills at every stage and every level of the project cycle. This becomes particularly critical in being well prepared for successful procurement, contract negotiation and contract management during project execution. For this, as well as in the context of the Fourth Industrial Revolution, [new talent profiles](#) are required to respond to the rising needs of complex capital projects. To avoid conflict during the project, talent needs to be able to confidently navigate a multistakeholder project ecosystem. [Systemic leaders](#), leaders that are able to lead organizations, systems, industries, communities and even nations through transformative change – as well as skilled stakeholder managers who are trained in conflict resolution – are required also to be able to navigate along the project's boundaries, including involving government, civil society, the public and asset end-users. This also includes the management of communities who might become an essential source of conflict at any stage of the project. Skilled talent is able to anticipate and understand the execution constraints and is able to find reasonable shared solutions. On an even broader scale and time frame, a system leader will be able to successfully navigate public engagement and political cycles to ensure the viability of the capital project.
- 3) **Be conscious that less is more.** Some of the most successful deals are based on very short documents while focusing on trust and integrity between the project partners. The management of capital projects that puts truthful collaboration in the centre of the relationship also comes with a focused view to prevent and avoid disputes whenever possible. One way to achieve this is to break the traditional “client-provider” relation and replace it with partnership frameworks involving project owners, contractors, designers, technology providers, O&M operators as team members to jointly develop solutions for the problems that will arise during project execution – e.g., “alliance contracting” used in Australia. Putting the relationship, and not the contract, at the centre is critical, and as Warren Buffett, who is renowned for his handshake deals and one-page contracts, puts it: “You can't make a good deal with a bad person.” Therefore, consider a concise, smart, agile, value-driven and performance-based contractual framework that focuses on the final asset and its service delivery. And when it comes to contract administration, put the relationship first.

- 4) **Set up effective project development and contracting frameworks** based on risks- and profit-sharing schemes and on performance, and decoupled from political cycles. Ensure that during the project-planning phase potential issues and risks have been jointly envisaged and contemplated in advance, and various alternative dispute resolution clauses have been incorporated in the deal or agreement under consideration. Develop strategies to increase the value-creating function of a contract, which should not only be drafted as a legal document – focusing on risk allocation – but also as an effective business tool focusing on vital value-creation goals. Ensure that the agreement encourages contracting and project management practices that incentivize coordination, transparency and anticipation. Set up proper contract administration procedures with integrated alternative dispute resolution tools and resources, which can enable effective conflict management, conflict resolution and conflict transformation. For this, dedicate more energy, time and resources to the ways and means that may be put in place to prevent and avoid disputes.
- 5) **Implement dispute prevention mechanisms.** There is strong scientific evidence that the sooner a destructive conflict is resolved, the higher the probability of resolution success and the lower the total cost. A prevention and an early resolution ensures there is still access to stakeholders familiar with the dispute, project cash flow will be less affected, and relationships critical to the success of the project can be maintained and/or revived. Furthermore, prevention and amicable settlements can minimize distraction from the core business, which will avoid cumulative negative effects. To allow timeliness, it is necessary to establish effective dispute avoidance mechanisms when the project is initiated. In this view, one of the most efficient prevention mechanisms is the Dispute Board. This is a permanent and independent body whose function is to assist the parties in preventing and resolving any disputes immediately when they arise. The Dispute Board, as efficient and innovative tool for the prevention and resolution of dispute, leads to avoid unnecessary, long and costly legal proceedings.
- 6) **Ensure amicable and timely settlement of any dispute.** Beside the Dispute Board, other alternative or amicable dispute resolution procedures, such as mediation, conciliation, collaborative law and amicable negotiations can minimize the probability of the need of dispute resolution, such as arbitration and litigation. If mediation is to be an effective conflict management process it must not be reduced to “shuttle diplomacy”; carrying offers and demands between parties, simply feeds back into and reinforces the cycle of reactivity. The mediation process must be structured to permit a reasoned dialogue on risks and options. This in turn necessitates:
  - Substantive briefing in advance, to enable the mediator to assimilate all critical legal and factual issues;
  - An initial joint session. Reactivity sets in so quickly, and is so potent, that one cannot reliably assume that decision makers have truly heard and understood the positions of the other parties - which is the predicate for an evaluative dialogue; and

- A caucusing process in which candid evaluation of risks and options can occur without fear of compromising negotiating positions.

7) **Look on the bright side** and be conscious that conflict can also be positive and transformational. Spot opportunities for early problem detection, increased mutual understanding and change management through conflict transformation mechanisms. Constructive conflict should be encouraged and destructive conflict that leads to disputes should be avoided. Constructive conflict results in better decisions by challenging assumptions and enabling innovation, and offers opportunities for constructive change. This change is urgently required to transform the industry and the way capital projects are being run by responding to the challenges of the digital age and being better able to apply technology that increases value for money, speed of delivery, asset quality, process transparency and overall coherence.

In sum, effective conflict management must reconfigure the lines of communication from the dialectic of trading arguments and positions between parties to a dialogue between each party and the mediator. Disburdened of reactivity, evaluations of issues and options by experienced business leaders tends to converge. Remaining gaps in positions can usually be bridged by a mediator's proposal, to which each party can respond initially in confidence without compromising negotiating positions.

A caucusing process, a practice mainly used in construction disputes, does not necessarily need to be the gold standard. The Harvard Mediation Program, for instance, promotes a so-called understanding-based approach to conflict where parties stay together throughout the process to making knowing and informed choices together. According to Robert H. Mnookin, Williston Professor of Law at the Harvard Law School, alternative dispute resolution, a set of practices and techniques aimed at permitting the resolution of legal disputes outside the courts, can reduce transaction costs since it is cheaper and faster than ordinary judicial proceedings; it can create resolutions that are better suited to the parties' underlying interests and needs; and it can improve ex-post compliance with the terms of the resolution. Mnookin contemplates that alternative dispute resolution techniques hold great promise for both the avoidance of disputes in the construction industry and for their prompt and fair resolution. According to Gary Friedman, mediation practitioner and author of the book *Challenging Conflict: Mediation Through Understanding*, the common approach of the construction sector to conflict resolution often places great power, explicitly or implicitly, in the hands of the mediator who shuttles back and forth between the disputing parties in an effort to assess the situation and broker a deal. Friedman is confident that the industry will tremendously benefit from our understanding-based approach by (a) assuming the responsibility for dealing with their conflict; (b) expanding the pie instead of splitting the pie; (c) strengthening their relationships; and (d) acknowledging that the results reached are far more satisfying and the path taken much more rewarding.



**In the Harvard Mediation Program, we consciously promote an understanding-based approach to conflict. In With this approach, the conflict professional seeks to work directly with the parties in an effort to support them finding resolution to their conflict. We are convinced that the parties are best suited to resolve their dispute and thus are able to come up with an optimal solution. Stated simply, we seek to support the parties in making knowing and informed choices together. We wish to do that in a way that is respectful of the parties and also fosters understanding and trust for themselves and for each other.**



Gary D. Friedman, Mediator, Center for Understanding in Conflict, Mill Valley, USA

We think that the future of alternative dispute resolution will be able to transform how we interact and collaborate on complex capital projects. Even in times of an emerging Fourth Industrial Revolution, human beings will still be at the core of conflicts and disputes and, therefore, an effective way of preventing and resolving conflict can only be through understanding.

As the Dalai Lama puts it: "Don't let a little dispute injure a great relationship. When you think everything is someone else's fault, you will suffer a lot. When you realize you have made a mistake, take immediate steps to correct it. When you realize that everything springs only from yourself, you will learn both peace and joy."



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