

DISPUTE RESOLUTION IN CONSTRUCTION CONTRACTS

The future success of projects in Australia's construction industry requires adequate scoping at the outset as well as adopting the procurement model best suited to the project, with an appropriate allocation of risk between the project participants. Investing time and money to get these issues right up-front will produce positive returns for all parties involved.

Pressure Points in Australian Projects
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1. Introduction

It is fifteen years since the Latham Report² came to the conclusion that the construction industry procedures in the UK were *ineffective, adversarial, fragmented, incapable of delivering for its customers and lacking respect for its employees*. That report was a wake up call for the construction industry in the UK, and further afield.

A clear indication of the state which the UK construction industry had got itself was in the dispute between Multiplex and its subcontractor, Cleveland Bridge, over the construction of the roof for the Wembley Stadium.³ The claim was for £6 million, for which Multiplex was successful. However, after two rounds of hearings over preliminary issues, two trips to the Court of Appeal, £22 million in legal fees, including almost £1 million in photocopying costs; Judge Jackson from the Technology and Construction Court was understandably scathing in his criticism of the parties.

The Latham Report focused on selection processes, tendering and construction procedures as being at the root of the problems facing the industry; and identified fifteen critical recommendations, many of which are particular to the UK. The common thread in the report was one of constructing a team based on natural talent, and playing to the skills of team members.

Of the fifteen recommendations, a number are of universal interest (I paraphrase):

- tender processes should be rationalised with greater focus of how partnering in construction projects can be enhanced

¹ Bill Smith, *Scope for Improvement – A Survey of Pressure Points in Australian Construction and Infrastructure Projects* [2007] 1 ICLR 36, at 54

² Sir Michael Latham, *Constructing the Team* - Final report of the government/industry review of procurement and contractual arrangements in the UK construction industry (1994 Department of the Environment)

³ This dispute actually arose some considerable time after the Latham Report, but it is symptomatic of the industry.

- the use of co-ordinated project information should be a contractual requirement
- design responsibility should be clarified
- roles should be clearly identified
- adjudication should be the norm for dispute resolution

One of the more significant results of the Latham Report has been the adoption of the NEC3 suite of contracts for over 90% of Government procurement contracts. The contracts are endorsed by the UK Office of Government Commerce, and are also being used, albeit in amended form, for the construction of facilities for the 2012 Olympic Games in London.

A similar review of the construction industry in Australia in May 2006 (see quote above) identified the early phases of the project as being critical to the success of construction and infrastructure projects. The survey found five main issues hampering construction and infrastructure projects:

- shortage of skilled resources (far and away the single biggest factor at a rate of over 5:1 among responses)
- inadequate scoping (42% of responses, with 46% saying more information would have helped)
- use of inappropriate delivery methods (20% responses felt the wrong delivery method was used)
- inequitable risk allocation (69% of contractors felt risks inappropriately allocated, but tendered anyway)
- unrealistic time and cost objectives (of projects surveyed, 39% not completed on time; 55% over budget)

Needless to say that the survey found that disputes are widespread; negotiation is the preferred method of resolution; and the majority of respondents were not satisfied with the time, cost, process and outcome of the dispute resolution methods used.

In Australia, as in New Zealand, there is a very strong preference to negotiate and agree on resolution, rather than to have a third party impose a decision, with considerable time and cost implications for the dispute resolution process. This position may well change with mandatory adjudication.

The main issues in dispute were:

- variations to scope (47%)
- contract interpretation (38%)
- extension of time claims (33%)

- site conditions (19%)

I would venture to suggest that while our Australian cousins can be more litigious, and their industry is larger, and they have a great pool of dispute specialists, a survey in New Zealand would reveal similar results.

There is one area in which the risks are particularly high, and in which New Zealand has a particularly poor track record; tunnelling. Of the three major tunnelling projects undertaken in New Zealand in the last 20 years; the Manapouri Tail Race project; the Penrose Tunnel; and Project Hobson (the Orakei sewer rehabilitation), two have gone to significant dispute.

Both concerned ground conditions, and the selection of tunnel boring methodologies. Manapouri was dealt with by Dispute Resolution Board, and Penrose was settled once most of the preparatory work was completed for a complex arbitration, but before formal hearings commenced.

Tunnelling is a tricky business. The extent of uncertainty in relation to ground conditions is considerable, yet the adherence to traditional allocations of risk, and procurement methodologies belie substantial project risks. The situation has become so bad that procuring insurance for major tunnelling projects can be problematic.

To deal with the problem, the International Tunnelling Insurance Group⁴ issued a Code of Practice in 2006.⁵ The objective of the Code is to promote best practice for the minimisation and management of risks associated with tunnelling works; it also provides a guide to good practice for construction works generally. Certainly for tunnelling works, if you depart from the Code, procuring insurance for the work becomes difficult.

From a procedural perspective, the Code is understandably focused on hazard identification and management of risk; the use of formalised risk management procedures is at the forefront of the recommendations in the code, and there is much in common with the comments from the Latham Report and the findings of the Australian survey. In the US, the *Yellow Book*⁶ makes similar recommendations, including the use of Dispute Resolution Boards to address the universal concerns about traditional tiered dispute resolution processes.

⁴ The drafting committee of the ITIG comprised representatives of the major reinsurers for construction work, Swiss Re, Zurich Global Corporate, Allianz AG, Scor, Munich Re, and Assicurazioni Generali

⁵ Based on *The Joint Code of Practice for Risk Management of Tunnel Works in the UK*, issued by the British Tunnelling Society and the Association of British Insurers in September 2003

⁶ *Guidelines on Geotechnical Baseline Reports* published by the American Society of Civil Engineers, 1997.

2. Traditional Approach to Dispute Resolution

The traditional approach to dispute resolution in New Zealand is reflected in the multi-tiered approach in Section 13 of NZS3910:2003:

- (1) *Engineer's review* (clause 13.2) – every dispute is to be referred to the Engineer no later than one month after the issue of the Final Payment Schedule or an Adjudicator's Determination, whichever is the later.

Procedurally, the contract is a little thin on how the Engineer is to proceed. Either the Engineer or the Contractor (notably, not the Principal, which raises interesting question about the impartiality of the Engineer in this context) may seek a meeting to discuss the dispute (see clause 13.2.2), and experts may be appointed (see clause 13.2.3). The Engineer is to give a formal decision within 20 working days (see clause 13.2.4).

The decision is to be final and binding on the parties (unless varied by mediation, arbitration or adjudication).

It is my view that the Engineer is in a position of real conflict of interest that would be unmanageable when measured against the tests of conflict of interest applied to other professions. The Engineer typically:

- is the designer
- prepared the contract documents (and advised the Principal on contracting strategy and allocation of risk)
- acted as the Principal's agent for the project (see clause 6.2.1(a))
- was to be independent and to act fairly and impartially in making decisions entrusted to him or her under the contract, particularly to value work and to issue certificates (see clause 6.2.1(b))

Bearing in mind the most common causes of project dispute identified above, it is fair to say that the Engineer had a hand in most disputes; and in many, the Engineer's own professional indemnity insurance must be at risk. The Engineer will almost certainly have a significant personal interest in the outcome; even if the Engineer achieves the superhuman effort of being independent in this capacity, this fails even the most basic test of conflict of interest.

In most of the recent forms of contract published internationally, this step in the dispute resolution process, if not the entire role of the independent Engineer, is done away with.⁷

⁷ There is some disagreement about whether or not the role of the *Project Manager* in NEC3 is also required to be independent and impartial. At this stage, the issue is not settled,

- (2) *Mediation* (clause 13.3) – if the parties are dissatisfied with the determination of the Engineer (or no determination is forthcoming), then the matter may be referred to mediation.

Where mediation is *acceded to*, the parties are to endeavour to agree on a mediator (see clause 13.3.3). The mediator is to discuss the dispute with the parties and *endeavour to resolve it by their agreement*. All discussions in the mediation are without prejudice, though whether or not that would make disclosures unrelated to the dispute covered by privilege is a moot point.⁸

Somewhere curiously, the mediator can be invited to give a *decision* on the dispute (see clause 13.3.4).

If there is no agreement to go to mediation, a mediator cannot be agreed, there is no agreement in the mediation and no *determination* by the mediator or a party rejects the determination, then the matter may be referred to arbitration (see clause 13.3.5).

- (3) *Arbitration* (clause 13.4) – if the parties are unhappy with the Engineer's decision, or no decision has been made by the Engineer, the dispute may be referred to arbitration.

It is interesting to note that mediation may be bypassed. It is only an option to refer a dispute to mediation under clause 13.3, and in my experience, disputes tend to go straight from the Engineer to arbitration if they go any further.

As in the Australian survey, New Zealand Principals tend to have considerably more comfort in their own negotiating ability, with or without a mediator, than they do in a mediator's ability to give an acceptable determination. I should add that they prospect of a mediator making a determination based on without prejudice discussions is pretty unattractive.

The dispute is to be determined by a sole arbitrator in terms of the Arbitration Act 1996 (without departing from the standard provisions in Schedules).

NZS3910:2003 is reasonably standard in approach to dispute resolution (with the curious exception of the mediator making a determination). However, it fails to address the issues confronting the construction industry, as identified in both the Latham Report and in the Australian survey. It is almost certainly for that reason that

though there are some clear expressions on the matter – see Humphrey Lloyd QC, *Some Thoughts on NEC3* [2008] 4 ICLR 468. at pages 475 to 478

⁸ See *Just Hotel Limited v Jesudhass* [2007] NZCA 582 for a discussion on privilege in mediation discussions.

most construction disputes get settled in New Zealand, in spite of the provisions of the contract, rather than any direct benefit they provide to disputing parties.

The provisions also fail to address the adversarial nature of projects tendered on the basis of a fixed price, lump sum, frequently on incomplete design, poor scoping and an inappropriate allocation of risk.

This calls into question the quality of the negotiated settlements achieved. It also, perhaps, explains the increasing popularity of adjudication under the Construction Contracts Act, at the cost of arbitration.

3. Disputes Review Tribunals under FIDIC

The FIDIC suite of contracts⁹ adopts a more co-operative approach by providing for a Dispute Adjudication Board (see clauses 20.2 to 20.4), followed by amicable settlement (clause 20.5), and arbitration (clause 20.6).

The Disputes Adjudication Board (DAB) is to be appointed by agreement and can be as few as one person. The default position is three.

The Procedural Rules for the DAB provide for the following (regardless of whether or not a dispute has arise):

- site visits at intervals of not more than 140 days
- the DAB is to be provided with copies of the contract documents, progress reports, variation instructions, certificates and other contract communications
- the DAB is to act fairly and impartially in accordance with the rules of natural justice
- the DAB may conduct a hearing
- the DAB may be inquisitorial
- the DAB may set its own procedures, including excluding lawyers from participating in the hearing

In general terms, DAB's provide greater independence from the traditional approach of using the Engineer to formally determine disputes, and they have the potential to bypass expensive arbitration or litigation. By appointing the DAB at the commencement of the work, the DAB is also fully aware of the work, its progress and the nature of the dispute before it has crystallised.

The downside of DAB's, particularly in the NEW Zealand context, is that they are perceived as being expensive. I have provided for DAB's in a number of large

⁹ A set of Conditions of Contract for Construction (Red Book), Plant and Design-Build (Orange Book) and EPC/Turnkey Projects (Silver Book) published in 1999 by the International Federation of Consulting Engineers.

construction projects in the past, but in each case the parties have declined to formally appoint them.

If the parties do not dispute the DABs' decision within 28 days, it becomes final and binding. If it is disputed, it is then referred to arbitration (see clause 20.6).

4. Adjudication under NEC3

The NEC3 suite of contracts cover virtually every permutation and every level of contract documentation in the same language and with a consistent allocation of risk, from professional consultant's appointment, through to a Short Contract for minor construction works, full contract terms for fixed price, cost plus and management contracts, whether employer's design or design and construct, and forms of subcontracts and adjudicators' appointments.

The central theme of the NEC3 contracts is that the parties are to deal with each other in the *spirit of mutual trust and cooperation*.¹⁰

In keeping with the recommendations of the Latham Report, the NEC3 contracts all prefer adjudication, followed by final determination by a tribunal, for which the default is arbitration.

As NEC3 is primarily a UK contract, its default provisions relate to the UK adjudication procedure. For non-UK contracts, there is a detailed adjudication agreement and procedure provided.

From a New Zealand context, the alternative (non-UK) is not particularly helpful. Minor amendment is required to ensure that the New Zealand adjudication procedures in the Construction Contracts Act are completed before any reference to arbitration.

The benefits of adjudication under the Act are clear. In practice, however, they have been less than successful in providing interim relief in ongoing contracts. The tendency has been for matters to be referred to adjudication only at the end of the project, or when it is apparent that the project has fallen over.

This suggests that a further less procedural interim relief is required.

¹⁰ See clause 10.1 in each form of contract

5. Alternative non-adversarial approaches

Alliances

Increasingly in tendered projects, particularly those of a high value and complexity, alliances are being used.

Under an alliance, there is no formally tendered documentation (in the traditional sense). The project is undertaken under an alliance agreement, which sets the processes under which the works are defined, carried out and paid for.

The critical elements of alliances are:

- the project tends to be only loosely defined, with a considerable level of design detail unresolved, and only a bare basis for costing
- all decisions in relation to the project which affect design, cost, or timing are made by the Project Alliance Board, of which the owner is but one member, along with the contractor and the designer
- all decisions are made in the best interests of the project
- the project budget is defined as the Target Outturn Cost. This represents the budget for the project works, less the contractor's margin (what is called Limb 2)
- the contractor is entitled to be paid the Actual Outturn Cost, whatever that may be, plus the agreed margin, which may be adjusted
- if the Actual Outturn Cost is less than the Target Outturn Cost, then the contractor and the owner share in the savings in agreed proportions
- if the Actual Outturn Cost is more than the Target Outturn Cost, then the contractor's agreed margin is reduced by an agreed proportion of the overrun. Once the margin is exhausted, the contractor gets paid only the Actual Outturn Cost
- the Target Outturn Cost is revised by the Project Alliance Board for what would normally be changes in scope or variations, and for what would normally be the unforeseen
- there is a binding contractual commitment not to dispute, unless the dispute arises as a result of fraud or matters of a similarly serious nature.

Alliance projects are touted as providing high performance teams and delivering projects early and under budget, which rather begs the question about the budget and the time available.

They are also universally presented as providing an alternative to the traditional adversarial approach to contracting. This is undoubtedly true. However, that does not mean that true partnerships and cooperative relationships cannot be provided

under other contracting structures which are more precise in the roles of the parties and which more accurately allocate risk.

The difficulty with alliances is that in too many areas where the contractor has particular expertise, the owner is brought into the allocation of risk through the Project Alliance Board. By assuring payment of actual cost, and bringing the design team and the construction team into the decision making process, the only constraints on a cost blowout are:

- the Project Alliance Board holding to the Target Outturn Cost, which is difficult, and
- the contractor's incentive to bring cost in below that target.

As the contractor is paid the entire actual outturn cost, there is little incentive to share that saving with the owner by coming in under the target. The biggest incentive is to push increases to the Target Outturn Cost through the Project Alliance Board, thereby ensuring the payment of cost and keeping the margin whole.

In most cases, the owner also has little to add to the critical issues dealt with by the Project Alliance Board, as they would normally rest with the design team or the contractor.

In relation to dispute resolution, it will be interesting to see if a dispute is referred to adjudication or arbitration, whether or not the agreement not to dispute is upheld.

My observation has been that alliances appear to be a very expensive way of contracting, and they are particularly attractive to contractors. I have not yet seen an alliance which could not have been deal with using a form of contract like NEC3, but with time and effort to working through the detail before the contract is priced and formally entered into.

Project Mediation

A further alternative approach to dispute resolution is to appoint a mediator for the project at the outset.¹¹

Under the Project Mediation Protocol, the parties appoint a mediator for the project on award. The project mediator then fulfils three functions:

- on award, the project mediator calls a risk meeting (provided for already in NEC3), at which the parties identify their roles and lines of communication, and they then work through the project risk register identifying potential risk issues and the consequences of the risk arising (early warning, in NEC3)

¹¹ I have prepared a New Zealand version of the Project Mediation Protocol provided by CEDR. Copies of the protocol can be downloaded from www.johnwalton.co.nz

- the parties copy the project mediator with all contract communications (in a similar manner to the DAB above). The project mediator can discuss any issues which may arise with either of the parties in an endeavour to avoid disputes arising
- if disputes eventuate, the project mediator undertakes a formal mediation, with the obvious benefits that he or she has a full knowledge of the parties, the project and the dispute

Project mediation answers a number of criticisms raised by the Latham Report and the Australian survey, without the expense of a formally appointed DAB. It also provides a more informal initial potential for resolution of disputes before an issue is escalated to adjudication.

6. Conclusion

The role of arbitration in providing a final venue for the resolution of construction dispute is assured. Arbitration allows the parties to select their decision makers based on their expertise and skills, they can set their own procedure and venue, and the result is confidential.

The popularity of adjudication, however, reveals how little weight the parties to construction contracts often place on the intricacies of the finer details of the law, and the benefits of full blown investigations of the facts and conducting hearings.

The real issue for construction projects is having a prompt and effective method of addressing disputes as they arise, and in a manner which enables the parties to continue the project without becoming distracted by the issues raised by the management of the dispute.

Legislating for goodwill and trust is helpful, but some form of independent interim dispute resolver, whether an expert, an adjudicator, or a project mediator is critical to maintaining progress on projects. While negotiation is useful, sometimes a third party can achieve considerably more by providing an interim opinion the parties can live with.

All too often, if they can live with it, they will not ultimately challenge the position as none of the parties to construction contracts are in business to engage in disputes; traditional procurement processes and contract documents may drive them in that direction, but generally they have better things to do.

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