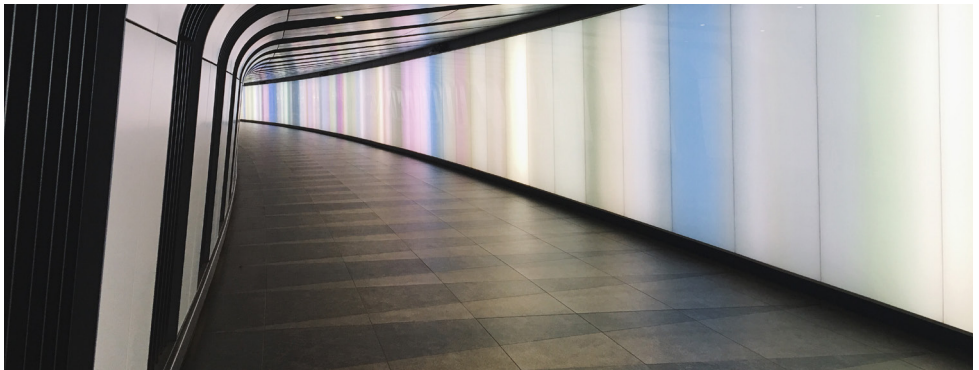


Counting the cost by Murray Armes

Litigation has always been expensive but the signs are that it is becoming increasingly so. A survey conducted by the US Chamber Institute for Legal Reform and others¹ showed that costs were increasing at a faster rate than increases in hourly rates. In the UK cost budgeting introduced by the Jackson Reforms has made participants more aware of the need to control costs but it is too early to say whether this has reduced them². Things are little better with international arbitration where both delay and costs appear to be rising³. The costs of litigation, and by implication, arbitration, also have a wider impact (some say they do actual economic harm) to society as a whole as a larger part of company budgets, resources and productivity are invested in litigation rather than productively in research, capital investment and market development⁴. Anything that might help to reduce both the actual and consequential costs of disputes must be beneficial.

The way to reduce the cost of disputes is to try to avoid them in the first place and I have written previously about how that can be achieved⁵, namely by the use of Dispute Boards (DBs). If Dispute Boards offers such advantages why are they not more widely used, and surely the DB process itself must involve costs?



There are a number of barriers to the wider use of DBs:

- Lack of knowledge of the process
- Lack of knowledge about effectiveness
- Lack of locally available DB members
- Suspicion about another layer of dispute resolution
- Employer had previous adverse decisions
- Not final and binding
- Enforceability
- Concerns about the costs

There are a number of organisations which are working to address most of the list above (including the DRBF), and this article is concerned with the last item on the list: costs. For anyone concerned with costs and faced with the choice of using a DB a few questions might arise:

- What does a Dispute Board cost?
- Why do I need one before any disputes arise?
- It must be expensive to have three members?
- It must be expensive for them to travel?
- Why should I not stick with arbitration or litigation?
- What is the cost of a DB compared to the alternatives?

Whether exponents of DBs like it or not, DBs are perceived to be expensive. Firstly the DB is constituted at the beginning of the contract, before any disputes have arisen. Secondly, DBs, especially for larger projects, comprise three or, sometimes, more members⁶. Sometimes Board members might have not been appointed from the local area, meaning travel and accommodation costs are a significant part of the cost of the process. This has been because experienced DB members were simply not available in some parts of the world (although DRBF training programmes are changing this) and there may also have been concerns about the impartiality of local members in a market that in some countries can be very small. This can lead to members being recruited from abroad and often from countries where the costs of living and therefore incomes were higher. Thirdly, parties might be concerned that the costs of the DB are incurred, even if there are no disputes. Of course, the fact the Board is in place might be the reason that was the case!

Figures have been cited for years that have suggested the costs of a typical DB was around 0.1%-0.25% of the total construction costs of a project. The typical cost of a DB can be calculated by reference to past experience. For instance, in Florida member rates are typically \$1500-\$3000 per day. In order to control costs some public bodies only allow half-day meetings. Study time (for contract documents and site visit reports) of about four hours per month is allowed in addition. Assuming a daily rate of \$2000, and a three-person Board, each meeting costs \$6000, twelve meetings per year cost \$72,000. Taking account of study time, travel⁷ and writing of decisions, the annual cost is about \$75,000. The authorities report that the cost is about the same despite the size of the project, so clearly the DB will be more cost effective on larger projects. The Florida Department of Transportation has used DBs on about 750 projects, typically of \$15m and above. The total value of the projects is about \$17bn and the cost of DRBs to date amounts to about \$17.5m, or, on average, about 0.1% of the construction cost of each project.

For a DB the costs amount to:

- Daily fees for Board members for site visits
- Retainer fee (or hourly/daily rate for reviewing documents and keeping up to date)
- Daily fees for Board members for hearings
- Cost of producing the decision
- Travel and accommodation costs

Added to this are the costs for each party of representation and the costs of the venue for hearings. Site visits usually take place using facilities already available on site. A study of the costs of international DBs published in the *Journal of Management and Engineering* in 2010⁸ suggested that for most projects site visits were carried out 3-4 times per year; that disputes were referred in 0-51% of projects; the cost of site visits assuming a DB of three members with fees of \$3000 per day (on the high side) was \$81,000 per annum. The cost of the retainer, assuming one day per month at \$3000 for each DB member was \$108,000 per year. The cost of the DB per annum, assuming no disputes, was therefore \$189,000. It was suggested each dispute would cost about \$54,000⁹. It was estimated that for a project with a value of \$100m-\$400m lasting four years the total cost with no disputes amounted to \$756,000, the cost of, say, five disputes would be \$270,000, so the total cost of the DB was \$1,026,000 amounting to 0.2-0.04% of the cost of the project. For comparison, a single ICC arbitration with a value of \$5,000,000 would cost in the region of \$300,000¹⁰.

In Australia¹¹ research has shown that the cost of a typical three member DB is around 0.15% for an A\$300m contract, falling to about 0.09% for a project larger than A\$400m. One-member DBs work out on average to be about 0.09% of the cost of a project below A\$100m.

This all points to the costs of the DB being insignificant compared to the cost of the project itself, and very good value when compared with the costs of international arbitration. Even so, there are times when DBs are still difficult to afford. For instance most international development banks will not include the cost of the DB as part of the loan for projects in developing countries. Such countries may simply be unable to afford the DB and may have insufficient foreign exchange to pay the DB even if it were affordable. Although most banks classify the DB process as "litigation", one does allow the borrower to include the costs within its loan and also provides the means by which the costs can be estimated. That bank is the Japan International Co-Operation Agency (JICA) which in 2012 published its enormously influential JICA Dispute Board Manual¹². The pro forma used to calculate DB costs includes two examples, the first for a single person DB:

- DB member is a resident in the country.
- Daily fee is US\$2,000/day and retainer fee is US\$2,000/month.
- Construction term: 2 years
- Number of DB members: 1
- Frequency of site visits: 3 (6 total in 2 years)
- Termination: at expiry of Defects Notification Period and 1 year after TOC, fee is two thirds daily rate
- Assume 2 referrals to DB during construction

The total cost was calculated to be \$145,000.

For the three person DB, JICA assumed:

- DB members are from foreign countries.

- Daily fee is US\$3,000/day and retainer fee is US\$3,000/month.
- Construction term: 4 years
- Number of DB members: 3
- Site visit: 3 days and average travel time: 3 days
- Frequency of site visits: 3 (9 total in 3 years)
- Termination: at expiry of Defects Notification Period and 1 year after TOC, fee is two thirds daily rate
- Assume 3 referrals to DB during construction

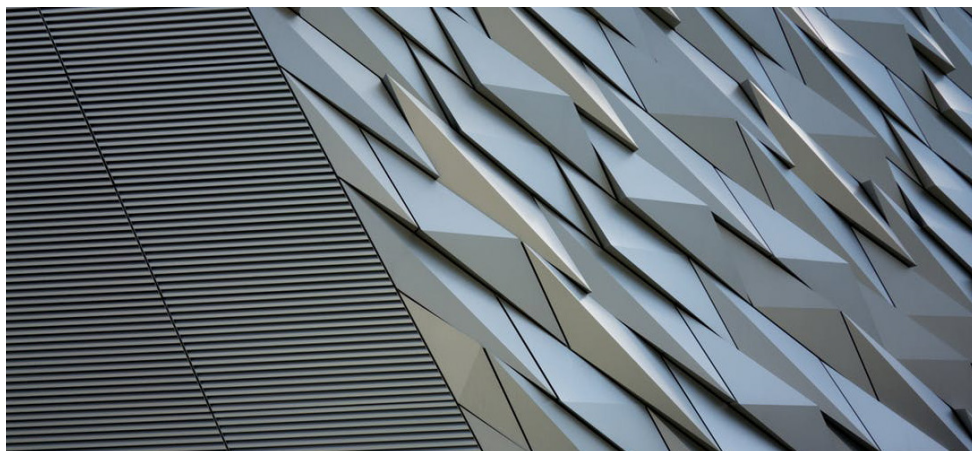
In this case the total cost was calculated to be \$1,368,000.

Clearly the project where the three-member Board was appointed would have been much larger than that with the single person. Assuming the costs were about 0.1% of the project costs the values would have been about \$14.5m and \$137m respectively. Evidence suggests that 60% of disputes have a value of 0-10% of the project cost¹³. For the two examples this amounts to disputes worth \$725,000 and \$6.85m assuming the value is 5% of the construction cost. For the two-member Board we have assumed two referrals of \$725,000, which the ICC costs calculator predicts would each cost about \$50,000 in arbitrators and administrative costs (for a one person arbitration tribunal), so about \$100k in total. For the three-member Board, three disputes valued at \$6.85m would cost about \$340,000 each, a total of \$1,020,000 in arbitrator's fees and administrative costs (assuming a three person arbitration tribunal).

Although both scenarios work out to be less than the fees for the DB, remember they do not include the costs to the parties for representation and the internal management time need to deal with the disputes. This adds a large amount to the costs of arbitration and means the costs of the DB are less than the alternative. The DB process has the added benefit that it is usually much quicker to resolve disputes than arbitration, and the real reason the DB is used is to prevent the disputes, and the costs and disruption they entail, from crystallising in the first place.

Although the proponents of DBs claim they are good value, just like in litigation, with the Jackson Reforms in the UK, there is pressure to keep costs down. So, how can DBs be made to be cheaper? Firstly, a single person DB is cheaper than three persons but the parties should always remember what type of expertise and the range required to deal with dispute avoidance and resolution for complex projects. Sometimes a single person is a poor investment. Secondly, the use of locally based members reduces travel and accommodation costs and if local living costs are lower then savings can be made on the fees charged by foreign DB members. It should be remembered though that properly trained and high quality and neutral DB members are not always (or at least not yet) readily available in some parts of the world. The DB can assist by ensuring the DB processes, whether dispute avoidance or dispute resolution, are not too legalistic and do not require an army of lawyers and legal advisors.

One of the real sticking points to the wider use of DBs though, and one often quoted by the development banks, is the retainer fee. This evolved from a provision in the World Bank 1995 edition of its “Procurement of Works” document in which the DB members were required to be available at seven calendar days’ notice. The original fee to compensate for that availability was three times the daily rate, which based on International Centre for Settlement of Investment Disputes (ICSID) rates of the time was about \$750. However, since then the requirement to be available at very short notice has been relaxed, but at the same time the daily fees for ICSID arbitrators, which were the basis for DB fees, increased dramatically to \$3000 per day. For a three person DB the retainer fees alone could amount to \$27,000 per month, which for a three year project amounts to almost \$1m, and that is without daily fees, which for three site visits per year would amount to about \$567,000. Those figures do not include travel and accommodation which are seldom insignificant.



So, should DB members consider dropping the retainer fee? There are arguments both for and against. There is no doubt the members will have to keep up to date with the project and preparatory work is required if the site visits are to run smoothly. But should such substantial amounts be paid regardless of whether the DB members actually do any work in any particular month? If the DB has a substantial amount of work to do each month the fixed \$9000 per month could be seen as good value but not all months are going to be busy. My own view is that a better approach would be charge for what the DB members actually do by applying an agreed hourly rate for work done outside site visits and hearings.

Despite the apparent pressure from employers for retainer fees to be dispensed with, the recent overhaul of the ICC Dispute Board Rules have kept them intact, except they are termed “Monthly Management Fees” rather than retainers. Although the DB will carry out

some management, that is primarily the role of the Chair and the individual members may not be called upon to do very much. There is no doubt that all the DB members will have to stay up to date but its arguable whether an agreed time charge would not be a better, fairer and more transparent way of charging for time away from the site.

If retainer fees were excluded from the two examples above from the JICA Manual the costs would be reduced by \$63,600 for the single member Board and \$504,000 for the three member Board, or 43% for the one member and 37% for the three member Board. Although something would be added back for time charges for work outside the regular site visits and hearings, the psychological effect this might have on potential users might persuade them that DBs are very good value after all. Dispensing with retainer fees also makes the DB process much more cost favourable when comparing the process to ICC arbitration, something which employers are going to notice.

It has been suggested that DBs are rather like an insurance policy against the cost of traditional methods of dispute resolution. Potential users though have to be persuaded the insurance cost is good value when comparing it with the alternative. In this article so far I have looked purely at financial costs. Research carried out in Australia suggests that the use of DBs has a beneficial effect in reducing delays and cost overruns, not just in reducing the costs of disputes which in many projects do not arise. The figures are startling. The research suggests that the chance of an "industry norm project running late is 2.3 times greater on projects that do not have a DB and the chance of such a project running more than three months late is 6.5 times greater than projects with a DB and that there is a greater than 80% chance that a project with a DB will be completed at, or shortly after, the contract date for Practical Completion, compared to less than 50% for the industry norm. The research also suggests that final contract cost of a project with a DB is 3-5% lower than a project without a DB in place.

The research done to date suggests that DBs really can provide excellent value for money with savings both directly and indirectly in time and money, not only in reducing disputes, but in actual savings in time and money of the project itself. It just remains for DB members to change their approach to fees so that retainer fees are replaced by transparent hourly rates to make the whole package as attractive as possible for potential users.

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- 1 *Litigation Cost Survey of Major Companies, by Lawyers for Civil Justice, The Civil Justice Reform Group and the U.S. Chamber Institute for Legal Reform, 2010.*
- 2 *Litigation Trends-The Jackson Effect, Revolutionary Road, new Law Journal, 2013*
- 3 *CIArb Costs of International Arbitration Survey 2011, The Chartered Institute of Arbitrators and International Arbitration Research based report on perceptions of document production in the arbitration process, by Berwin Leighton Paisner, 2013*
- 4 *Excessive Private Litigation: The Impact on Business and Consumers, EU private Litigation Paper, published by the IBA, 2005.*
- 5 *Everybody Has Won and All Must Have Prizes, by Murray Armes, Construction Law Journal, November 2011 and The Concept of Dispute Avoidance, by Murray Armes, paper given at the Kings College Annual Conference 2011 and published in the DRBF "Forum" in December 2011.*
- 6 *Most international arbitration tribunals also comprise three arbitrators.*
- 7 *Most public bodies in the US use locally available members and place limitations on the distance between where the DB member resides and the project, or place limitations on the amount of travel cost which is reimbursable.*
- 8 *"Analysis of Dispute Review Board Application in US Construction Projects from 1975-2007" by Carol Menassa and Feniosky Pena-Mora, 2010.*
- 9 *Allowing for 6 days including travel, site visit and hearing and decision; note that depending on the complexity this may under estimate the time required to produce the decision.*
- 10 *ICC Arbitration Cost Calculator: <http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/cost-and-payment/cost-calculator/>*
- 11 *The Benefit/Cost Equation for Dispute Boards-Australian Experience, paper given by Graeme Peck at the DRBF International Conference, May 2014.*
- 12 *JICA Dispute Board Manual, March 2012, available from: http://www.jica.go.jp/activities/schemes/finance_co/procedure/guideline/pdf/DisputeBoardManual_201203_e.pdf*
- 13 *The Benefit/Cost Equation for Dispute Boards-Australian Experience, paper given by Graeme Peck at the DRBF International Conference, Singapore, May 2014.*