

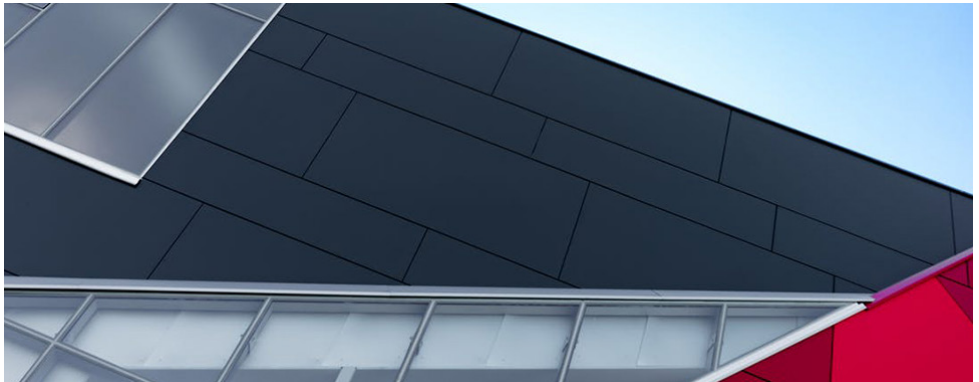
## **“Putting Your Money Where Your Mouth Is” or “Practising What You Preach”: The Funding (or not) of Dispute Boards by the International Funding Banks**

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Construction projects; Dispute boards ; Expenses; International banks; Project finance

### **Introduction**

FIDIC contracts are unique because they are the only international standard form suite of contracts to promote dispute avoidance. The vehicle for this is the Dispute Adjudication Board (DAB) and the first role of the DAB is to help the contracting parties avoid disputes, disputes which are inevitably costly in money, time and reputations.



The international development banks have recognised it is highly worthwhile dealing with issues before they become fully blown disputes and the World Bank has been promoting the use of Dispute Review Boards (DRB)<sup>1</sup> in its Standard Bidding Document since 1995. The World Bank has also made provision for the settlement of disputes by a DAB<sup>2</sup> in its Procurement Guidelines,<sup>3</sup> since 1999 when they were first published and which still exist today.<sup>4</sup> The World Bank, together with the European Bank for Reconstruction and Development, Asian Development Bank and African Development Bank were instrumental in drafting and promoting the FIDIC MDB Harmonised Edition (published in 2005) of its well known Conditions of Contract for Construction 1999,<sup>5</sup> known as the “Pink Book”. Most of the other international funding banks have now joined these banks in promoting and encouraging their borrowers to use the FIDIC MDB Contract.

Provided it remains unamended, the MDB Contract provides for the establishment of a Dispute Board (DB) under subcl.20.2, which states that:

“Disputes shall be referred to a DB for decision in accordance with Sub Clause 20.4... The Parties shall appoint a DB by the date stated in the Contract Data.”

The contract makes provision for much more than just the settlement of disputes by the DAB and encompasses the full range of DB services, including the all important provisions for dispute avoidance. To assist in this, the MDB Contract provides for a standing board, allowing the board to monitor the project, attend site, meet the parties and help them deal with issues before they become disputes. The DAB is also empowered to provide informal assistance and guidance in the form of non binding opinions.<sup>6</sup> The MDB Contract therefore provides for dispute avoidance and by promoting its use the funding banks are themselves promoting the concept of dispute avoidance.

Despite this, there are some major international projects in which DABs are not being used<sup>7</sup>; yet these are projects that would have almost certainly benefitted from the use of a DAB. This article will explore why, despite funding banks promoting their use, DABs are often not used, what the policies are of the banks that do actively promote DABs and the consequences of not doing so. Finally we will look to the future to a way forward that will help to ensure more DABs are established.

### Dispute Boards

For those unfamiliar with Dispute Boards,<sup>8</sup> I will very briefly describe what they are. According to Totterdill and Owen<sup>9</sup>: “A DB is a tribunal which is established to endeavour to avoid or resolve any disputes which may arise between the parties to a particular contract.” A DB typically comprises one, or three persons, although a larger odd number of members can be appointed, experienced in the type of project to be carried out and in dispute resolution. A typical board may include a mix of disciplines, which might include an engineer, lawyer and quantum member. Normally one member is appointed by each party; the two of them then select the chairperson.

FIDIC contracts provide for the use of DABs rather than DRBs<sup>10</sup> and depending on which FIDIC contract is used there are two basic types of board: standing and ad hoc. A standing board is appointed at the outset of the contract and monitors the project and actively takes part in avoiding disputes, adjudicating any that cannot be avoided. An ad hoc board is appointed to resolve a single dispute and has no dispute avoidance function. The MDB Contract provides for the use of a standing board.

DBs are successful in most parts of the world<sup>11</sup>. Whilst a typical DB costs 0.05 per cent — 0.26 per cent<sup>12</sup> of the construction costs, about 99 per cent of disputes referred are resolved in less than 90 days. The average cost is about 0.02 per cent of the value of the dispute and 98 per cent of referred disputes end with the DB. Of the 2 per cent remaining, half are subsequently upheld in arbitration; of the 1 per cent of decisions upset by arbitration, or the courts, almost all concern procedural irregularity, and not the substance of the decision.<sup>13</sup>

There are two types of dispute resolution: reactive and proactive. Reactive dispute resolution means the parties have already taken up positions and possibly started formal proceedings such as litigation, or arbitration. Even mediation, which is viewed as a consensual process, is still reactive because the parties have established their positions and these will be used as a basis for negotiation. Dispute avoidance is the only form of proactive dispute resolution, consisting of the resolution of issues by the parties, assisted by a third party (in this case the DB) if necessary, before they become formal disputes.

### Why are DABs sometimes not used?

Despite this success and despite provision being made in the MDB Contract, DABs are still often not established. It is generally the employer (or borrower in the case of a MDB Contract) that has control of the contractual provisions. There may be many reasons why a borrower decides to delete the DAB provisions from a contract. Possibly they have suffered what they regard as poor experience, often in the form of decisions adverse to their position<sup>14</sup> or perhaps they have been poorly served by an inexperienced, or dysfunctional board, possibly selected from a pool of poorly trained, or unsuitable individuals.

A DB represents what can be seen as another layer of dispute resolution and a lack of education and training about DBs may mean that a borrower is unaware of the benefits of having a properly appointed, experienced board. Or perhaps at the commencement of a contract, when relationships are still intact, both parties may have unrealistically optimistic expectations for a dispute free project, which is something that rarely occurs. However, the main reason why DBs are not appointed concerns the matter of cost. We have seen above that typically the cost of a DB is a very small proportion of the overall value of a contract, but the actual cost is not insignificant, particularly on a large, complex project scheduled to be constructed over a long period. Typically, projects which involve the international funding banks take place in the developing world, where funding for such projects would otherwise be unavailable. Borrower nations, who are reliant on the loans from development banks, may not have access to any other funding to support the project, so if anything is required that lies outside the funds made available by the banks, they cannot be implemented by the borrower. If the bank does not include the cost of a DB in its funding package, the borrower may not have the funds, or access to sufficient foreign currency to pay for it which might, at worst, encourage the deletion of the DAB provisions, or at best delay the appointment of the board.

The funding banks are not direct users of DABs, nonetheless their value is recognised by them and they are indirectly promoting their use through the MDB Contract. Notwithstanding that, there is no consistent policy between different banks for the provision for funding of DBs as part of the project costs. This means that, as we shall see, some banks do allow for the cost of the DB within the overall provision of funds, whilst others do not.

The consequences of not funding the DAB and not funding training

Below I have listed what are the likely consequences if funds are not available for the establishment of a DB?<sup>15</sup>

- Where the contract makes provision for a standing board, the parties delay establishing the board until after a dispute has arisen which they are unable to resolve by negotiation. Under the MDB Contract, the only way a dispute can be resolved in arbitration is to seek a DB decision first. Therefore the parties resort to the appointment of an ad hoc board and the intended dispute avoidance role of the board is lost.
- A standing board is established at the commencement of the contract, but to save money the board is allowed to visit infrequently, perhaps only once per year, so the benefits of allowing the board to monitor and keep up to date with the project, together with proactive dispute avoidance are diminished.
- Board members are selected by price competition, with little, or no evaluation of other facets of a potential board member's suitability for service on the particular project, leading possibly to a poor quality board and at worst a dysfunctional board. To save money, board members from the locality, whether properly qualified, or not, may be nominated, which may diminish the effectiveness of the board, or give rise to a perception of bias, real bias, or at worst corruption.
- A single board member is appointed for a complex job. The benefits of having a board of several members with varied experience are lost.
- In an effort to save money, an ad hoc board is agreed, even though its use on the type of project involved is contrary to the provisions of the MDB Contract, the opportunities for dispute avoidance are lost.
- To save money, the borrower seldom (if at all) appears at site during the board site visits, the opportunities for dispute avoidance are diminished, or at worst lost. Because visits are conducted in the presence of only one party, the impartiality of the board and any decisions it makes may be brought into question.
- Lacking the financing to pay any sums awarded by a board, all decisions favourable to the contractor are not honoured and are referred to arbitration in order to postpone any actual payment for as long as possible.



Another issue is the funding of education. Without education and training the parties, including funders, will not be able to make best use of the DB, let alone understand the benefits of having one in the first place. In fact, the parties may not even understand how to establish a DB, or where to find suitable DB members for nomination. Although, in the first instance, the education of the borrower is the most important, because it will be the borrower which has control of the contract documentation, there are real benefits of informing tenderers about the DB process, which can lead to lower tender prices<sup>16</sup> and a better attitude to the project as a whole. However, education should really start with the funding banks themselves so that they are fully aware of exactly what the process is that they are promoting and the benefits for the participants and the project as a whole and so the banks can in turn help to educate the borrowers. Training need not be expensive; the African Development Bank has been encouraging training in conjunction with the Dispute Resolution Board Foundation (DRBF)<sup>17</sup> and to date a number of very successful training courses have been completed. The DRBF has also been involved in training in conjunction with the Japanese International Cooperation Agency (JICA), which has led to the development of the JICA Training Kit, which in turn has been used very successfully to educate and train participants in FIDIC contracts, as well as potential DB members.<sup>18</sup>

Without assistance from the funding banks, borrowers may not have the funds available for training. Possible consequences that arise out of a lack of training might be:

- The borrower does not understand the role of the DB. At worst this may lead to deletion of the DB provisions from the contract. Any opportunity for dispute avoidance is lost and all disputes have to be referred to arbitration.
- Borrower and contractor do not understand how the DB is to be used. Even if a DB is established, neither party is aware of the benefits the DB can bring, they may be unaware of the ways in which the DB can assist with informal negotiations, including giving informal opinions to guide the parties before any formal dispute resolution procedures are adopted.
- Borrower and contractor do not understand the dispute avoidance role. Dispute avoidance is the key benefit of establishing a DB; by referring disputes too early, without the opportunity for discussion, some of the benefits of dispute avoidance may be lost.
- The borrower is unable to guide tenderers. Some tenderers, particularly if they have not experienced a DB before, may be wary about the use of a DB. Borrowers are able to provide information and reassurances that the DB can bring benefits for both parties and that the DB is a good investment.
- The borrower is unable to promote advantages (which may lead to better tenders). In fact, many contractors that have been engaged on projects with DBs now prefer to have a DB included because there is a greater chance they will be dealt with fairly and the inclusion of a DB may lead to a more favourable tender price.
- Funders themselves can benefit from education and training to properly understand the benefits a DB can bring and to assist in encouraging and educating borrowers to use DBs and for them to make decisions about the provision of funds for the establishment of a DB.

## The way forward

One of the problems with the inclusion of the costs of a DB within the overall funding of a project is the calculation of its cost. The cost of a DB will be dependent on the length of the contract, the number of DB members, the amount of their fees, the frequency of site visits and the number of disputes referred. Not all of these can be easily established at the time funds are being applied for. However, one bank is making efforts to ensure that its borrowers do make adequate allowance for the cost of a DB which JICA will include in the project funding. Although other development banks do also make funds available for DBs, it is not clear what their motives are. Possibly it is because they realise that, once a serious problem has arisen, it is in their interests to allow the borrower to have funds to deal with it, or perhaps the more cynical view is that the banks are simply happy to lend further funds on the basis they are going to get the money back from the borrower at some point.

JICA, though, has been pre eminent in the promotion of DBs. Its “Guidelines for Procurement under Japanese ODA Loans” (March 2009)<sup>19</sup> include the words:

“Provisions dealing with the settlement of disputes shall be included in the conditions of contract... In case of works contracts, supply and installation contracts, and turnkey contracts, the dispute settlement provision shall include mechanisms such as dispute boards or adjudicators, which are designed to permit a speedier dispute settlement.”

More recently, in March 2012, JICA published its “Dispute Board Manual”.<sup>20</sup> In appendix 3, s.3.2, it includes the words:

“In case of Japanese ODA (Official Development Assistance) Loan, the DB cost is considered to be an essential cost for the project implementation, thus it is an eligible cost under Japanese ODA loan. On the other hand, cost for arbitration is not covered.”

In s.3 of the manual, entitled “Consideration at Pre-Implementation Stage” it is stated:

“Before implementation of the Contract it is important for a Borrower to make adequate and sufficient financial arrangements for the cost of a DB. It is important to allocate the DB costs by the Employer or the Financier, ... and assistance in estimating cost of the DB is included in Appendix 3.2.”

Appendix 3.2 explains what the principal costs of a DB are and how they are normally invoiced and broken down into retainer fee, daily fee and expenses. The appendix includes a budgeting technique for one and three person DBs and the borrower is expected to provide an estimate of the likely costs of the DB, including an estimate of funds required to finance the DB’s fees when resolving disputes. This is an innovative approach to establishing the likely costs of a DB to be included as part of the funding package, which to my knowledge is not yet promoted by any other bank, although there is no reason why that should not be the case.

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This approach to DB funding is not followed, for instance, by the EU. Under the Instrument of Pre-Accession Assistance (IPA) Commission Regulations,<sup>21</sup> Ch.III, art.34, “Eligibility of Expenditure”, has these words under para.3:

“The following expenditure shall not be eligible under the IPA Regulation:  
...(d) fines, financial penalties and expenses of litigation; ...”

In these regulations, the European Union seems to assume that all disputes will be dealt with by litigation. However, the European Union is a promoter of mediation and in 2011 passed its Directive on Mediation.<sup>22</sup> Although mediation has proved to be a successful, consensual and cost effective method of dispute resolution, it takes place only after a dispute has crystallised and the parties have taken up their positions. A more effective way of dealing with issues is to deal with them before this happens and before the issues have developed into a formal dispute. This is what the standing DAB does. It might well use mediation techniques to negotiate with the parties and to encourage them to negotiate amongst themselves, but the DB process as a whole is not to be mistaken for mediation.<sup>23</sup> As we saw before, mediation is a reactive form of dispute resolution, whilst the DB process, if properly and fully implemented, is proactive.

What is important to define is exactly what is meant by “litigation” and whether the DB process is properly included in such a term? Under the FIDIC MDB Contract, the DB performs a number of key functions<sup>24</sup>:

- monitoring the project;
- regular site visits;
- meetings with the parties;
- reviews of issues;
- assistance in resolving issues;
- informal opinions.

The aim of the DB in performing these functions is to facilitate solutions and avoid disputes. However, unless specific reference is made to these functions being carried out by the DB, the reader might have thought that they were part of the services provided by the engineer, or the contract administrator and of course that would be correct.

These functions, none of which in my view could be described as “litigation”, are part of the project management of the contract and were traditionally carried out by the engineer, or contract administrator. It is only more recently that they have been transferred to a neutral decision-making entity because of suspicions that the engineer’s determinations could be influenced because he was being paid by the employer. This is why the DB now takes on the decision-making role the engineer traditionally had. If used properly by the parties, the DB should use all these project management skills before there is any need to refer the dispute for a decision.



Of course, the above list does not include all of the functions a DB has to perform because should dispute avoidance fail to resolve the issues, either party may formally refer a dispute to the DB. It is only after the project management procedures have been exhausted that dispute resolution has to be resorted to. In fact, under the FIDIC MDB Contract a DB decision is required before a final and binding resolution in arbitration can be commenced. The DB procedure can be considered to be in two parts: the dispute avoidance procedures which are essentially part of the project management of the contract, and the more formal dispute resolution procedures and therefore the DB represents a portal between the project management of the contract and the first step to dispute resolution which might finally lead to arbitral proceedings.

Traditionally, the cost of the engineer, or project manager has been included as part of the borrower's funding package, so why cannot at least parts of the DB's services be funded by the banks, even those opposed to funding "litigation"? The parts of the DB process which seem to me to fall outside the definition of "litigation" comprise:

- the DAB retainer costs;
- DAB site visits;
- DAB meetings with parties;
- DAB informal assistance.

Although the JICA policy of funding the whole process is to be preferred, not least because adjudication of disputes by the DAB is much quicker and cheaper than resorting to international arbitration, nonetheless, if only these listed parts of the DB process were funded, at least the contract would retain the provisions for proactive dispute avoidance, through the provision of a standing DB.



## Conclusion

The international funding banks, encouraged by the World Bank, have supported and continue to support the use of the FIDIC MDB Contract by its borrowers. By doing so, these banks are promoting the concept of dispute avoidance and the mechanism by which this is implemented with the provision of a DB. Although DBs have been successful in reducing the costs of conflict and are cheap compared to litigation, or arbitration, their costs are not insignificant. These are costs the borrower may not be able to pay, unless those costs are included as part of the overall funding for the project.

It is difficult to understand some development banks' concerns, because on the one hand they are lending large sums for the procurement of major infrastructure projects and yet a small amount of money cannot be made available to put a DB in place to help avoid costly and time-consuming disputes. It is not unknown for large projects to be let for hundreds of millions of euros, funded by a development bank, where the government agency borrower has not, for example, properly investigated land ownership, which has led to disputes costing those governments, the banks and tax payers far in excess of anything than is ever spent on the provision of a DB.

JICA not only promotes the use of DBs it provides a mechanism by which a borrower can estimate the cost of a DB to be included within the funding package. Some banks will not fund what is considered to be litigation, but it is questionable whether the most important part of what a DB does amounts to litigation, because it is more closely aligned with project management. For a funding bank unable to fund the whole of the DB process, there is no reason why at least the front end dispute avoidance services should not be part of the funding package.

The wider adoption of DBs relies on all parties to a contract being educated in their advantages and how to use them. There are therefore good reasons why the funding banks should support education and training and help in making borrowers and contractors alike more aware of DBs. Assistance in training and education is available from organisations such as the DRBF and FIDIC and both can assist in helping parties find suitable DB members from a pool of very experienced, well regarded and highly trained potential board members, which already exists, and education will of course help to ensure that pool is maintained.

So what of the future? If more banks provided funds to allow a DB to be established, there would be no reason why borrowers needed to delete the provisions from the contract, meaning more boards will be established. The use of more DBs means more successful projects, less costs expended in dispute resolution and the preservation of better relations between the parties as a result. The funding banks support the use of the MDB Contract, so the challenge, as I see it, is for all of them to put their money where their mouths are, to practise what they preach and to support the one feature that makes the MDB Contract unique: dispute avoidance.

- 1 A DRB is empowered to give non-binding recommendations. This model is used widely in the United States.
- 2 A DAB is empowered to give binding decisions. This is the model promoted by FIDIC and is used widely on projects outside the US.
- 3 World Bank Procurement Guidelines (1999), s.2.42 "Applicable Law and Settlement of Disputes".
- 4 World Bank Procurement Guidelines (May 2010), s.XIII, "Disputes Settlement Procedure".
- 5 Known as the "The Red Book".
- 6 Under subcl.20.2 of the contract.
- 7 A recent European Bank of Reconstruction and Development survey revealed that users of the MDB Contract considered that DABs were rarely used and that they were ineffective. The reasons were that due to a lack of funding of the DAB their establishment was often delayed, so the board was ad hoc and the dispute avoidance function was lost.
- 8 For more information on DBs the reader is referred to Gwyn Owen and Brian Totterdill's *Dispute Board Procedures and Practice* (London: Thomas Telford Publishing, 2008) and Chern on *Dispute Boards: Practice and Procedure* (London: Wiley-Blackwell, 2008).
- 9 Owen and Totterdill, *Dispute Board Procedures and Practice* (2008), p.4.
- 10 A DAB issues binding decisions and this is the most usual form of DB used in international projects. In the US DRBs are more common and they issue non binding opinions for the guidance of the parties. The ICC has introduced a third variant known as the Combined Dispute Board (CDB), in which the parties can choose whether the board issues a decision, or an opinion.
- 11 In some countries, such as Romania, DBs have proved less successful, mainly because employers are not prepared to implement DB decisions, or in some cases to make provision for the DB at all.
- 12 At the DRBF 16th Annual Meeting in October 2012, statistics for American style DRBs showed the typical cost was about 0.1 per cent of the contract value.
- 13 Statistics and data provided by the Dispute Resolution Board Foundation (DRBF).
- 14 The Romanian Roads Authority resisted the use of DBs after experiencing this, and deleted the DB provisions from their contracts, but the backlash from European contractors caused them to reconsider.
- 15 The consequences of a lack of funding for DBs was first considered by Gordon Jaynes in his paper "Dispute Boards – Form and Substance" given at a regional conference in Brussels organised by the DRBF, in November 2011 on which have based this list.
- 16 Evidence suggests that tenderers favour projects that have DBs because it means that disputes will be dealt with quickly and cheaply.
- 17 Information can be found at <http://www.drb.org/> [Accessed February 12, 2013].
- 18 For more details see the paper by Professor Toshihiko Omoto "JICA's Efforts for the Promotion of the Use of Dispute Boards (DB) in the Asian Region", given at the DRBF International Conference in Sydney in May 2012 and available at <http://www.drbconferences.org/documents/Sydney/OmotoPaper.pdf> [Accessed February 12, 2013].
- 19 See s.18 in Ch.2, entitled "Settlement of Disputes".
- 20 JICA "Dispute Board Manual", March 2012, available at [http://www.jica.go.jp/english/operations/schemes/oda\\_loans/oda\\_op\\_info/guide/pdf/guide09.pdf](http://www.jica.go.jp/english/operations/schemes/oda_loans/oda_op_info/guide/pdf/guide09.pdf) [Accessed 25 February, 2013]
- 21 Commission Regulation (EC) No.718/2007, June 12, 2007.
- 22 The Cross Border Mediation (EU Directive) Regulations 2011.
- 23 DB procedures should always take place with both parties present and without caucusing, or ex parte communications. The ICC DB Rules do make provision for private meetings, but this author considers that these should be used with great caution.
- 24 These are set out under FIDIC MDB Dispute Board Procedural Rules, annexed to the general conditions and in the case of informal opinions, subcl.20.2.