

***Supporting the CPR Dispute Reduction Initiative:***

**PREVENTION PRACTICE MATERIALS**

**AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE**

*A stitch in time saves nine*

**BE PREPARED**

Fortune favors the prepared mind

**FIX THE PROBLEM, NOT THE BLAME**

**It usually costs less to avoid getting into trouble than to pay for getting out of trouble**

**The highest and best form of dispute resolution is dispute prevention**

**DISPUTE RESOLUTION COSTS MONEY. DISPUTE PREVENTION SAVES MONEY.**

***CPR Prevention Practice Materials:***

**Reducing Disputes Through Wise Prevention Processes in Business Agreements**

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## INTRODUCTION

CPR presents in this booklet a suite of practice materials that will explain some of the wide variety of available processes for prevention, control and early resolution of disputes, and provide useful practice information on how these processes can best be deployed to advantage in the negotiation and drafting of business agreements and corporate governance protocols.

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## 1. A PRACTICAL EXERCISE FOR BUSINESS LEADERS AND THEIR INSIDE COUNSEL

### Questions which should be addressed to every corporate leader, manager, and inside counsel:

1. During the past two years, has your business experienced any disputes in its “business-to-business” relationships?
2. If so, have any of those disputes been significant enough to:
  - a. Cause your business to incur substantial “transaction costs” (i. e., lawyers’ and experts’ fees, etc., as contrasted with damage payments to the other party)\* to obtain resolution of the dispute in litigation, arbitration, or mediation?
  - b. Interfere with the efficiency or success of the underlying business transaction, activity or enterprise?
  - c. Damage future relationships with the other party to the dispute?
3. Would you like to be able to minimize the number and severity of business to business disputes?

If you answered “yes” to any of these questions, then you should find these CPR Dispute Reduction Practice Materials useful to you and your business.

### **There are ways to prevent, reduce, manage and control disputes in business to business relationships**

There are proven techniques that help businesses to anticipate, prevent, manage and control the growth of problems and unexpected events that often escalate into harmful disputes with other businesses.

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\* “Transactional resolution costs” have been defined as “the costs that are incurred because of the presence of a dispute including direct costs (such as fees and expenses paid to lawyers, paralegals, accountants, claims consultants, and other expert), indirect costs (such as salaries and associated overhead of in-house lawyers, company managers, and other employees who have to assemble the facts, serve as witnesses and otherwise process the dispute), and (to the extent they can be measured) hidden costs (such as the inefficiencies, delays, loss of quality that disputes cause ... and the costs of strained business relations between the contracting parties.” Gibson, G. E., Gebken, R. J., *Decision Making, Transactional Costs and Dispute Resolution: Is There a Better Way?*

A small proactive investment of “preventive” time at the commencement of a business relationship can pay great dividends to both parties by improving relationships, insuring against disputes, and saving money for both parties.

If the parties to a business relationship were to take time during the negotiation of the terms of their relationship to jointly “think ahead” about the future course of their relationship and acknowledge the possibility that unexpected events or other problems might threaten their relationship, they could provide in their contract one or more processes that would guide both parties constructively when they are confronted with such problems.

The existence of agreed-upon processes for realistically and rationally dealing with unexpected events will channel the parties’ problem-solving efforts constructively; avoid the chaos that can ensue if there are no recognized rules for dealing with a problem; encourage the parties to “fix the problem rather than fix the blame;” and prevent a problem from escalating into an adversarial confrontation or a dispute.

### **Selecting preventive processes from the available menu**

The selection of which processes are most appropriate to channel the parties’ problem-solving efforts should depend upon such factors as the parties’ mutual assessment of what kinds of problems might arise during their relationship, and how the parties want to deal with those problems. *(A full menu of processes, and sample language for implementing them, can be found in Section 5 of these Practice Materials, beginning on page 17.)* Some of the available processes help the parties to align their interests through collaborative efforts or incentives. Other processes help to curb disputes by injecting a neutral “dose of reality” into a potentially divisive difference or opinion or disagreement.

An example of a “collaborative” process is Partnering, a team-building effort in which the parties establish working relationships through a mutually-developed strategy of commitment and communication. The relationship is built on trust, dedication to common goals, and understanding of each others’ individual expectations and values. The expected benefits from such a relationship include improved efficiencies and cost effectiveness, increased opportunity for innovation, continued improvement of quality, and a lasting relationship. Partnering is usually instituted at the beginning of a relationship by holding a retreat among all personnel involved in the enterprise who have leadership and management responsibilities, in which the participants, assisted by an independent facilitator, become acquainted with each others’ objectives and expectations, recognize common aims, develop a teamwork approach, initiate open communications, and establish non-adversarial processes for resolving potential problems.

In cases where a neutral “dose of reality” would assist in curbing a dispute in a long term relationship where an unknown variety of problems might arise, the parties, at the beginning of the relationship, might identify a wise person, known to and respected by both parties, who is

familiar with the type of relationship or contract, who would be available on reasonably short notice to provide objective advice to the parties whenever the parties could not agree among themselves about how to solve a problem.

Experience has shown that the mere existence of such a respected person in whom both parties have confidence, who is familiar with the parties' relationship and objectives, and will be available to provide advice throughout the course of parties' relationship, encourages the parties to deal realistically with each other and thus resolve problems themselves, often without ever having to refer them to the standing neutral

Further experience has shown that on those few occasions when the agreed-upon neutral has actually had to render advice, the parties, guided by the neutral's "dose of reality," have almost invariably reached a consensual solution to the problem without having to resort to any formal dispute resolution process.

Prime examples of relationships where problems can arise, and where preventive processes could help to control the escalation of problems into disputes where a standing neutral could provide valuable assistance in curbing disputes, are joint ventures, long-and medium-term supply agreements, outsourcing arrangements, and agreements for exchange or sharing of services or resources.

Some other business relationships which could benefit from such a standing neutral would be franchise agreements, and a topical example from the auto industry's current problems: the relationship between the central organization and its major customers and franchisees -- dealers, chain owners, etc.

A full menu and description of devices, techniques and processes for preventing and controlling disputes, along with sample contract language illustrating how those processes can be implemented, is contained in Paper Number 5 in these Practice Materials.

## 2. “THINKING AHEAD: A “NEW PARADIGM” IN BUSINESS RELATIONSHIPS

CPR recognizes that some of the most successful businesses use principles of thinking ahead, anticipation, and prevention in their contracting relationships, both to prevent problems from occurring, and if problems and unexpected events do occur, by controlling and managing those events in ways that keep them from escalating into real disputes.

This new paradigm is characterized by a number of fairly simple, logical and straightforward principles:

- a. Both contracting parties view their relationship as one of working together to advance the business enterprise or transaction.
- b. Both contracting parties understand and respect the forces driving their opposite number.
- c. Neither seeks unfair advantage or “something for nothing”.
- d. Both parties recognize the reality that problems and unexpected events will occur during the course of their relationship.
- e. Both parties recognize the expense and waste that are inherent in an extended and escalating dispute resolution process.
- f. Therefore both parties, at the inception of the relationship, together try proactively to anticipate and identify the kinds of potential problems that might arise in the future.
- g. Based on this mutual evaluation, the parties select and set up a series of processes that will encourage cooperation, keep problems from escalating, and make certain that any disagreements are promptly resolved. (Among these techniques are such processes as: early identification of potential areas of problems and disputes, incentives to encourage cooperation, partnering, and standing neutrals.)
- h. The parties incorporate these processes into the contract that governs their relationship.
- i. The parties keep channels of communication open and functioning.
- j. When a problem or unexpected event occurs, both parties recognize that they have already committed themselves to seek a quick, fair, and equitable solution to the problem without escalation to the dispute level.
- k. Senior managers of both parties make their policies regarding dispute prevention and resolution clear to counter-parties and subordinates, and they insist on adherence.
- l. All parties recognize and reward exemplary performance.

This paradigm, and its contrast with current private dispute resolution practice, can be graphically illustrated by the “Thinking Ahead” flow chart which appears on the next page..

The chart lays out two quite different paths:

The first path, on the left side, describes the current "typical" approach that most businesses and lawyers follow when they are negotiating a business deal, where the standard behavior is to deal with the possibility of future problems with penalties and perhaps a boilerplate mediation and or arbitration clause, and then describes the occurrence of problems and the typical ways that problems are handled and finally resolved, frequently with serious expense and damage to relationships.

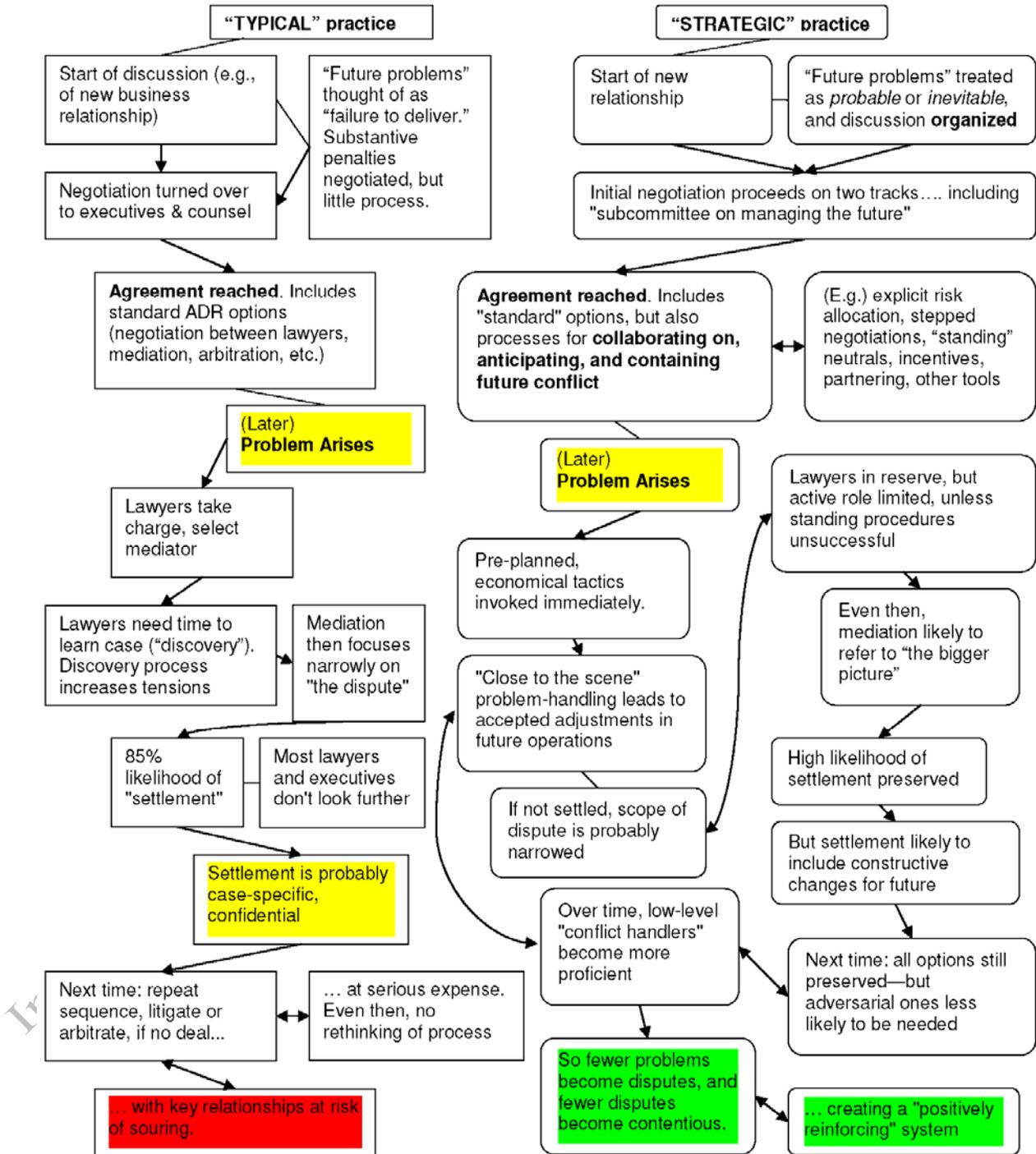
Next, a parallel “Strategic Behavior” path on the right side of the page describes a contrasting course: a set of much more sophisticated practices that are modeled on the ideal model of construction industry preventive behavior, beginning with the collaborative anticipation of problems, agreement on processes for dealing with problems, the application of those processes when a problem occurs, solution of the problem, the avoidance of a dispute, and continuance of beneficial relationships.

One of the most valuable features of the second Strategic Behavior chart is the concept of having the initial negotiations between the parties proceed on two tracks:

(1) The traditional “deal negotiation” track, to determine the substantive commercial aspects of the enterprise; and

(2) A second collaborative negotiating track composed of representatives of both parties who would constitute a "subcommittee on managing the future," who would try to anticipate in a non-adversarial way the kinds of problems that could come up during the course of the business relationship, and then craft mutually beneficial processes to include in the contract that would direct any such problems into constructive tracks so they could be dealt with realistically in a problem-solving, not adversarial, context.

**Thinking Ahead to Avert Problems:**  
the “typical” approach versus the “strategic”  
*(basic version. © Christopher Honeyman 2008, used by permission)*



### 3. PREVENTING AND RESOLVING CORPORATE GOVERNANCE DISPUTES

In the field of corporate governance, where relationships between various elements of the corporation's governance are governed by such documents as charters, by-laws and stockholder agreements, there are many opportunities for the relevant documents to contain agreed-upon processes for keeping inevitable differences of opinion and disagreements from escalating into harmful conflict

Corporate governance disputes primarily involve the corporation's shareholders, board members, and senior executives. They may also involve other stakeholders who challenge the company's governance, ethics or strategy. These disputes represent a particularly fruitful area for thinking ahead, because of the high risks and costs they often represent for the company. Since the board sits at the center of the governance process, resolving a corporate governance dispute typically requires the board's attention, even if the board or individual directors are not direct parties. This potentially imposes notable time and opportunity costs even in situations where the board may have initially perceived its role as marginal.

No single "thinking ahead" strategy is sufficient for these disputes, because they fall into two broad categories, internal and external, and these require quite different strategies.

#### *External disputes*

The disputes we are calling "external" are the ones likely to come first to most peoples' minds. These involve constituencies such as dissident or dominant shareholders who seek some kind of change in the company's policies, or in the board's composition. The constituency may also be another kind of stakeholder, such as employees or communities which have (or perceive) a systemic grievance they want the board rather than management to resolve. Anticipating this type of conflict is similar in structure and requirements to anticipating other kinds of major business conflicts discussed elsewhere in these Practice Materials, except that the stakes for the company are often higher. The same concerns about the adverse consequences of allowing a situation to fester, accepting "rosy scenarios" which presume there will be no conflict, and other elements of common corporate blindness apply, as do the strategies recommended for averting these errors. The only major difference is that in an external corporate governance dispute, provision should be made to have in place a process for resolving such disputes, preferably to include the prior appointment of a particularly high-status mediator, standing neutral, or other expert, in keeping with the status of many of the others involved, who can be available to intervene in the dispute. By definition, in many situations it will be unclear who the stakeholders for a potential future dispute may be, which raises the risk that a standing neutral appointed in advance may not be perceived as neutral by all of them because they did not have an equal opportunity to participate in the selection. Advance appointment of a standing neutral in conjunction with *likely* stakeholders, however, and with both advance instructions and a structure that requires the standing neutral to be

responsive to other stakeholders as may be appropriate in a given situation, is imperfect but still likely to be helpful.

### *Internal disputes*

The disputes we characterize as "internal" are quite different, both in structure and in the planning strategy necessary to avert them. These are disputes which occur among directors themselves, or between directors and the most senior members of management. Internal governance disputes often have their source in the relationship between the CEO and chairman, and/or other executive and nonexecutive board members. If a significant shareholder is also a member of the board, an internal dispute can take on a three-way, board-management-shareholder character. These disputes are probably the most disruptive of all to board decision-making. Unresolved, they can injure the board's ability to function for a long time (remember the HP board dispute over the merger with Compaq?), and reduce the overall company's performance accordingly. Yet without a subtle form of thinking ahead, this type of dispute is particularly likely to be allowed to fester -- partly because there are strong reasons for any board and particularly CEO to seek to maintain at least the *appearance* of harmony within the board. This makes for a particularly awkward situation when a dispute is looming: it is normal for at least some of those involved to deny that there is any conflict, and there is then no good way to call in an outsider for assistance without risking an open breach.

Good corporate governance in future therefore requires very particular strategies for working ahead of internal disputes. Two approaches are appropriate:

First, in order to obtain prior alignment of interests among board members and senior management, the corporation can take affirmative steps to improve communications among directors and between the board the CEO, and having board retreats where board members can identify common interests and concerns, focus on the corporate vision and mission, and formulate strategies.

Second, the board should ensure that there is an internal mediator or peacemaker *already on the board*. In one sense, this is a new form of practice for highly skilled "standing neutrals." In another sense, it is probably time-honored: were the secrets of boards' dealings more open to researchers, a close analysis of any board which is known to have worked smoothly through corporate crises over the years would almost certainly reveal a CEO who was wise (or lucky) enough to have recruited someone with real mediation skill to join the board. If verbatim transcripts were available, it would probably also turn out that the term "mediator" was never actually uttered, either in the recruitment, or in the occasional and vaguely stated request at a board meeting that "Jim, perhaps you could have a look at this situation and talk to everyone." (If the request is made on the phone in between board meetings, it is likely to be made considerably more forthrightly but even more privately.) Such an innocent and apparently offhand request, made to the right director at the right time, has probably saved more companies than we will ever know.

### *Other examples of Standing Neutrals in a Corporate Governance Context*

The concept of having already on the board one or more directors who can act as a sort of steadying influence to keep the peace can be especially useful in closely-held or family-owned corporations.

For example, in the case of a closely-held corporation where there might be deadlocks between equal owners, there are a couple of techniques that can be employed in drafting the corporate charter and by-laws that can avoid the paralysis of a deadlock by using one or more outside directors as standing neutrals:

1. One technique is for the stockholders who have evenly-divided interests to elect as a director a neutral outsider who is knowledgeable about the business and has a reputation for integrity. (An example of such a person could be the Dean of a local business school.) This outside director is paid a significant director's fee, is furnished the key management reports that are provided to other directors, and is expected to attend all board meetings, ask questions, participate in discussions, and get a good perspective on the affairs of the company. However, this outside director has a vote only in the case of a disagreement among the "inside" directors, in which case the outside director has the deciding vote.

2. Another technique, where there are two stockholders with equal ownership and a concern about possible deadlock, is to establish a five-person board of directors, two of whom represent the evenly-matched "insiders" and three of whom are highly-respected independent "outside" directors. They all function as a real board, and each director has a vote. The advantage of the arrangement is that in any case where the two inside directors disagree, it takes the votes of at least two of the three outside directors to carry the vote.

In the case of a corporation where there are two stockholders with a great disparity in ownership interests and a concern that the majority stockholder will ride roughshod over the minority stockholder to the detriment of the company, the charter could provide for a five-person board of directors, two of whom are appointed by the majority stockholder, one of whom is appointed by the minority stockholder, and two more highly-respected independent "outside" directors are appointed jointly by both stockholders together. Under this system, the majority needs the vote of only one independent director, while the minority needs the vote of both independent directors. But in a case where the majority is acting abusively, the independent directors are likely to perceive the potential for abuse, and both vote with the minority stockholder.

In the case of a family-owned corporation, intra-family disputes injurious to the corporation have been avoided by appointing independent directors to the board, along with representatives of the family, to act in effect as standing neutral board members, to serve in the role of internal peacemakers.

In all of the foregoing situations, because the independent outside director(s) can control the outcome, there is an incentive for all directors to exercise good judgment and act reasonably for the best interests of the company.

Alternatively, if a board of directors did not want to have a standing neutral actually as a member of the board, it could simply identify an outside person in whom its members have confidence, and appoint that person to be available to serve as a standing neutral resource in the event that the board members have a disagreement.

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#### 4. THE CASE FOR INCLUDING PROCESSES FOR PREVENTION AND CONTROL OF DISPUTES IN BUSINESS AGREEMENTS\*

Every relationship carries with it the potential for disputes. Common experience has demonstrated that problems, difficulties, differences of opinion, disagreements and disputes can occur at any time, even in the best of families and businesses. Given this reality of the business world, the parties to a business relationship, at the time they enter into that relationship, should always address the subject of how they are going to handle any problems or disputes that may arise between them. At this point they have a unique opportunity to exercise rational control over any disagreements that may arise, by specifying that any disagreements be processed in ways that are likely to avoid litigation, preferably by agreeing on a dispute resolution “system” that will first seek to *prevent* problems and disputes, and next establish a process for *resolution* of any disputes. There are many excellent reasons for taking advantage of the opportunity:

**Disadvantages of Litigation.** Resolution of a business problem through litigation:

- Deprives business leaders of the opportunity to maintain control over their disputes.
- Takes too long. It will take at least several months (and in some jurisdictions several years) to get a civil case to trial; appeals can lengthen the process by a year or more. This delay can create uncertainty in business planning, adversely affect cash flow, and have other disruptive effects on the business.
- Is too expensive. It costs a lot to bring even the simplest business dispute to trial, in lawyers’ fees, time and energy of business people, and costs of experts and consultants.
- Lacks expertise. The resolution of business and technical disputes requires expertise and sophistication. It is difficult to find judges with the qualifications to resolve such issues.
- Is too public. Court filings and proceedings are matters of public record. They are valuable sources of information for business competitors, and, if they are juicy enough or it’s a slow news day, they can be reported in the media.

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\* Adapted from Groton, J. P. and Haapio, H., *From Reaction to Proactive Action: Processes in Business Agreements*. International Association for Contract and Commercial Management Symposium Papers, 1997.

- Is too uncertain. Litigation is a very blunt instrument. It is often very difficult to predict how a judge or appellate court will ultimately resolve a case.
- Is too disruptive of business relationships. The hostility engendered by litigation makes it difficult for business people to continue to carry on normal business relationships and activities with each other.

Many of these reasons apply also to most modern-day arbitrations, which have become more and more like court litigation.

**Disadvantages of postponing a decision about how to deal with disagreements until after a problem or dispute has arisen.** Deferring consideration of how disputes will be dealt with reduces a party's options. Once a dispute has developed, it is often difficult to get the participants to agree on the time of day, let alone discuss rationally the optimum method for resolving the dispute. At this point the parties are likely to have different agendas and preferences as to how they would prefer to resolve the dispute. One party may want to emphasize the facts and equities, or sophisticated business realities; the other side may prefer to be in a court of law. One party may want a quick resolution; the other party may prefer delay. One party may want to avoid publicity; the other party might prefer public exposure of the controversy. Whenever the parties are unable to agree on the method of dispute resolution, the only remaining dispute resolution system, by default, will be litigation.

**Advantages of proactively agreeing early on a dispute processing system.** Agreeing at the very beginning of a relationship on a method for quick processing and resolution of any future problems or disputes that may arise has many advantages:

- Responsible business managers are accustomed to controlling costs, quality and other aspects of their business relationships. Using private dispute prevention and resolution techniques gives them an opportunity to control disputes as well.
- The beginning of the relationship, when there is an atmosphere of business-like cooperation, and before any disputes have arisen, is the time when the parties can most rationally discuss the optimum method for dealing with any disputes.
- Including the subject of dispute prevention and resolution as an element in the negotiations leading to the establishment of the relationship helps to define an important aspect of the relationship. For example, if you learn that the other party does not want to agree to have an efficient dispute prevention and resolution system, this knowledge can affect how you negotiate other terms of the agreement – or whether you want to enter into the relationship at all.

- Business people often have a real fear of a foreign legal system. Exhibiting a willingness during the negotiations to set up a rational, fair and prompt dispute resolution system should have special relevance in an international transaction.
- Agreeing early on a method for dealing with potential problems can lead to creative business-oriented results, be a cooperative and satisfying experience, and is likely to help to create and preserve continuing business relationships.
- The special importance of having a dispute prevention “process” already in place is often overlooked. An existing process will absorb the shock of unexpected events and problems. It channels them constructively, so they can be dealt with realistically and ultimately be solved. In the absence of a process, the parties are left to founder without direction, which can lead to confusion and chaos.
- The ready availability of a fair, efficient, trusted and quick method for processing disputes tends to discourage game-playing, posturing, and delaying tactics; may well encourage the parties to cooperate and deal realistically with each other; and may result in the parties resolving the problem by themselves, without having to resort to the dispute resolution procedure at all.

### **How to overcome resistance to the use of dispute prevention techniques**

Despite the acceptance of mediation and arbitration as dispute *resolution* alternatives to litigation in many areas of business, there is still considerable resistance to the techniques for *preventing and controlling* disputes. However, knowledgeable business professionals should recognize and overcome the kinds of obstacles and attitudes that can discourage parties from agreeing in advance on a system for preventing and controlling disputes. Some of these problems are:

**Not Wanting to Spoil the Euphoria.** Some people may fear that addressing the subject of dispute resolution during the early stages of a relationship is akin to suggesting to a happy engaged couple that they should enter into a pre-nuptial agreement. However, business should not be an emotional relationship; and ignoring the fact that problems and disputes can routinely occur even between the nicest people is simply a triumph of hope over reality.

**Traditional Resistance to Change.** Given the newness of dispute prevention, many contract and legal professionals have never before included it as a subject in their negotiation agendas and checklists. Accordingly, there is often a built-in resistance to any new idea. One argument for overcoming this resistance might be that preventing disputes can save money. Another argument might be that much of the impetus for preventing disputes comes from business people, and that contract and legal professionals would be well advised to keep up with their colleagues and clients.

**A Perception that Multi-level Dispute Resolution Slows Down the Process.**

Some people may feel that specifying more than one level of dispute prevention and resolution, such as partnering or a standing neutral or mediation before resorting to arbitration, imposes an unnecessary and delaying process that will retard the ultimate resolution of a dispute. However, sophisticated business and legal practitioners know that the earlier in the life of a problem or dispute the parties address the problem and deal with it realistically, the more likely they are to resolve it amicably; and that every dispute prevention and resolution system should contain a final and binding “backstop” resolution method of some kind, such as arbitration.

**A Perception By One Party That It Will Benefit From An Inefficient Method of Resolving Disputes.**

A party that thinks that it has – or is seeking – superior bargaining power may think that it will benefit by denying the other party an opportunity to have a dispute resolved promptly and efficiently. For example, a party that is obligated to pay money may, if the other party has no ready recourse, think that it can obtain leverage simply by withholding payment. Such a strategy ordinarily only works once, because once it is exercised, the other party won't be tricked again. And if such an intended strategy is revealed during contract negotiations, the other party can increase its pricing to offset the risk that it may be deprived of the use of its money for an extended period of time, or it may refuse to enter into the business relationship.

**Bottom Line:** In short, there is no rational excuse for a responsible business not to include in its agreements a system for processing disagreements as promptly and efficiently as possible.

## 5. A MENU OF PREVENTION, CONTROL AND “REAL TIME” RESOLUTION PROCESSES, AND EXAMPLES OF CONTRACT CLAUSES FOR IMPLEMENTING THOSE PROCESSES\*

Business have available to them a wide variety of techniques which can be adapted to prevent and control disputes in virtually any contractual business relationship. New techniques are being developed every day. Most of the techniques can readily be incorporated into contracts; other techniques can be employed in special situations.

These techniques form a continuum or spectrum that can be classified into four successive (and escalating) stages of dispute resolution:

- **Cooperation and Problem Prevention Stage.** The highest and best form of dispute resolution is prevention of problems and disputes. One of the best ways to prevent disputes is to establish an atmosphere of cooperation. Establishing clear communications, and techniques for encouraging alignment of interests and teamwork, such as partnering and incentives for cooperation, can create such an atmosphere, improve relationships, prevent some problems, and keep some disputes from arising.
- **Dispute Control Stage.** Dealing promptly and realistically with problems, differences of opinion and minor disagreements at the time they arise and before they can develop into full-fledged disputes can do much to contain and control disputes. Early negotiation, or obtaining “real time” dispute resolution assistance from a pre-selected standing neutral, can resolve disputes at the source and can even help in preventing the problem from escalating into a dispute.

If the parties are unable to solve problems through the use of Cooperation and Problem Prevention techniques, or Dispute Control techniques, then the process becomes transformed from dispute “prevention” to dispute “resolution.” At this point the parties lose some measure of control over the problem, because they will have to turn to “outsiders” (people who have not been directly involved in the relationship) for assistance in the resolution of the dispute. At this point the levels of hostility, cost, and time for achieving final resolution of the dispute begin to rise significantly.

- **Nonbinding Facilitated Resolution Stage.** When disagreements develop into real disputes, the parties should use structured, facilitated negotiations, assisted by a skilled negotiator, mediator, fact-finder or evaluator, or some other method of Alternative or Appropriate Dispute Resolution (ADR) to enable them to achieve a mutually-acceptable resolution of most disputes, to avoid having to turn the dispute over to an arbitrator or court for final resolution.

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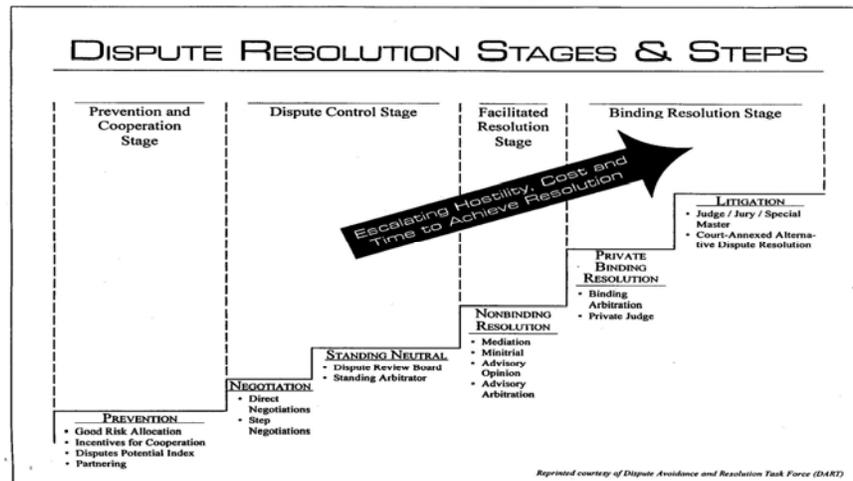
\* Adapted from Groton, J. P. and Haapio, H., *From Reaction to Proactive Action: Processes in Business Agreements*. International Association for Contract and Commercial Management Symposium Papers, 1997.

- **Binding Resolution Stage.** When all other efforts at resolution have failed, it is necessary to have a “back stop” adjudication process in which the dispute will ultimately be resolved by a third party – preferably in an expert, prompt, efficient and private manner – such as arbitration.

These stages can be graphically illustrated by the following “stair step” sequential model developed in the construction industry, which lists techniques in the order in which they would normally be employed in the life of the dispute, beginning first with the techniques that help most in preventing or controlling disputes and offer the greatest potential for saving money and preserving relationships

In this paper we will deal principally with techniques proactively preventing and controlling disputes, and therefore it will not address in any detail the well-known traditional ADR processes that are involved at the Nonbinding Facilitated Resolution Stage or the Binding Resolution Stage. However, it is prudent to note that any carefully-crafted dispute prevention and resolution process should recognize that every dispute resolution system must ultimately include a binding dispute resolution process. If the parties do not designate arbitration as their binding method, then, by default, litigation becomes the final and binding dispute resolution method.

## Dispute Resolution Stages and Steps



From James P. Groton: The “Up Front” Prevention, Control and Early Resolution of Disputes: Dispute Prevention and Management Lessons that Businesses Can Learn from the Construction Industry. A paper to be presented at the Conference “Commercial Contracting for Strategic Advantage – Potentials and Prospects” in Turku, Finland, June 2007, see <http://www.ccc-turku2007.org/program.html>.

None of these techniques is immutable, and they can all be adapted to fit the special needs of any particular transaction. Individual techniques from two or more stages can be combined into multi-level dispute resolution systems.

## **Specific techniques and illustrative language**

The contract planning and negotiation stage is the logical starting point for articulating techniques that have been proactively selected by the parties to prevent, control, reduce and resolve disputes. The existence in the contract of techniques for handling disputes, and the parties' knowledge that these techniques are readily available, will direct any disputes into channels where they can be dealt with constructively; in many cases their mere availability encourages the parties to act more forthrightly with each other and resolve their disputes without the necessity of using the prescribed techniques.

These proactive techniques are not rigid; they can be adapted to meet the needs of the parties, or the nature of the particular dispute. (It should be noted that the suggestions in this paper regarding use of contract language are not intended and should not be taken as legal advice.)

### **A. Proactively Promoting Good Cooperation and other Techniques to Prevent Disputes**

#### **Realistic Allocation of Risks**

One of the most powerful ways to prevent and control disputes between contracting parties is to rationally allocate risks by assigning each potential risk of the business relationship to the party who is best able to manage, control or insure against the particular risk. Conversely, unrealistic shifting of risks to a party who is not equipped to handle the risk can increase costs, sow the seeds of countless potential disputes, create distrust and resentment, and establish adversarial relationships that can interfere with the success of the business enterprise.

Unfortunately, this fundamental principle of good business management and dispute prevention is not widely recognized or understood. In particular, lawyers involved in contract negotiations for their clients who seek zealously to obtain the "best possible deal" by shifting all possible risks to the other party can sometimes create problems of a far greater magnitude than any temporary benefit or satisfaction gained by "winning" the "battle" of the contract negotiations.

Realistic risk allocation promotes efficiency, lowers costs, and creates better relationships. The result in nearly all cases will be fewer disputes and a greater chance for success of the enterprise.

In many cases it will be obvious that certain risks logically should be assigned to a particular party. Other risks can possibly be handled equally well by either party, and some risks may be such that they cannot be effectively handled or even insured against by either party; the assignment of those risks will have to be dealt with through bargaining, and the result of that bargaining will likely be reflected in the economic terms of the deal.

In a one-time short-term transaction between two parties who never expect to do business again with each other, it may not make a difference to anyone but the parties themselves if the party with superior bargaining power shifts risks to the other party that the other party can't control. However, in any business relationship of long duration or where there are repeated transactions, there are advantages to having a balanced relationship where neither party is exposed to inordinate risk, and where both parties profit. In multiple-party relationships, realistic assignments of risk are particularly important to the maintenance of healthy relationships and control of costs. In the classic multi-party example of the construction industry, an owner's use of superior bargaining power to shift risks unrealistically to another party typically creates a chain reaction of cost inflation, resentment, downstream risk-shifting, defensive and retaliatory tactics, and misunderstandings caused by different perceptions as to the enforceability of some risk-shifting provisions. The result is usually adversarial relationships, disputes and claims, which could have been avoided by intelligent sharing of risks.

### **Incentives to Encourage Cooperation**

Where a business is contracting with a number of different organizations which have diverse interests, and where the cooperation of all of these organizations with each other is important to the success of a transaction or business objective, it is often helpful to structure a system of incentives to encourage such cooperation. Well-conceived positive incentive programs can be an effective means of aligning the goals of all of the participants, can encourage superior performance, and discourage conflict. Such incentives can take many forms. One example of such an incentive system is the establishment by the leader organization of the enterprise of a bonus pool which, upon attainment of specific goals, will be shared among all of the people with whom the leader organization contracts. Under such a system the bonus is payable only if all of these participants as a group meet the assigned goals; the bonus is paid either to everyone, or to no one. This device provides a powerful incentive to the participants to work cooperatively with each other, and reduces conflicts which can occur in a common enterprise when every participant might otherwise be motivated solely by its limited perception of its own short-term interests, rather than the success of the enterprise as a whole. It encourages participants to subordinate their individual interests temporarily to the legitimate needs and success of the enterprise as a whole, for the ultimate benefit of all project participants.

Following is an example of language establishing an incentive plan, taken from a construction contract, where the general contractor, using funds provided by the owner of the project, seeks to encourage cooperative behavior among the subcontractors who are collectively performing the bulk of the on-site construction work:

#### ***BONUS POOL PLAN***

*The General Contractor will establish a Bonus Pool program offering every Subcontractor a cash incentive for achieving the Project Goals outlined below.*

*The Project Goals are:*

- a. *The project is completed by the Completion Date;*
- b. *There are no unresolved claims by any subcontractor for interference or damage by any other subcontractor or contractor; and*
- c. *There have been no accidents which have caused more than \_\_\_ work days to be lost.*

*If all of the Project Goals are achieved, the General Contractor will pay to each Subcontractor, in addition to each Subcontractor's normal compensation, a bonus of \_\_\_% of the Subcontractor's adjusted contract sum.*

### **Partnering**

Partnering is a team-building effort in which the parties establish cooperative working relationships through a mutually-developed, extra-contractual strategy of commitment and communication. It can be used for long-term relationships, or on a project-specific basis. The relationship is based upon trust, dedication to common goals, and understanding of each others' individual expectations and values. The expected benefits from such a relationship include improved efficiencies and cost effectiveness, increased opportunity for innovation, and continual improvement of quality products and services.

When used on a project-specific basis, partnering is usually instituted at the beginning of the relationship by holding a retreat among all personnel involved in the project who have leadership and management responsibilities, in which the participants, assisted by an independent facilitator, become acquainted with each others' objectives and expectations, recognize common aims, develop a teamwork approach, initiate open communications, and establish nonadversarial processes for resolving potential problems.

Partnering can be initiated on an ad hoc basis, or by the contract. It is essentially a good faith and non-contractual process. If initiated under the contract, care should be taken to preserve the extra-contractual nature of the process, unless the parties consciously want certain aspects of their partnering relationship to take on the status of contractual obligations.

A typical provision for initiating the voluntary partnering process would be as follows:

#### ***VOLUNTARY PARTNERING***

*The parties intend to encourage the foundation of a cohesive partnering relationship which will be structured to draw on the strengths of each organization to identify and achieve reciprocal goals, to accomplish the objectives of the contract for the mutual benefit of both parties.*

*This partnering relationship will be bilateral, and participation will be totally voluntary. Any cost associated with effectuating this partnering relationship will be agreed to by both parties and will be shared equally.*

*To implement this partnering initiative, at the beginning of the relationship representatives of the parties will initiate a partnering development seminar and team-building workshop. These individuals will make arrangements to determine attendees at the workshop, agenda of the workshop, duration, and location, and engage an independent facilitator. Persons required to be in attendance at the workshop will be key personnel from both organizations who are involved in operations under the contract. Representatives of organizations not parties to the contract may also be invited to attend as necessary or appropriate. Follow-up workshops may be held periodically throughout the duration of the contract as agreed by the parties.*

*The establishment of a partnering charter will not change the legal relationship of the parties to the contract nor relieve any party of any of the terms of the contract.*

### **Contractual terms that can enhance the partnering relationship**

Some people, particularly in the construction industry, believe that the best partnering relationships are founded on an explicit contractual commitment of good faith and reasonable (or fair) dealing. The laws of many countries impose an implied obligation of good faith and fair dealing in every contract. If the parties want to contractually confirm this kind of relationship, they can include an explicit contractual covenant of good faith and fair dealing, along the following lines:

*The parties, with a positive commitment to honesty and integrity, agree to the following mutual duties:*

- a. Each will assist in the other's performance;*
- b. Each will avoid hindering the other's performance;*
- c. Each will proceed to fulfill its obligations diligently;*
- d. Each will cooperate in the common endeavor of the contract.*

## **B. Dispute Control Techniques**

### **Negotiation**

Negotiation is the time-honored method by which parties try to resolve disputes through discussions and mutual agreement. Negotiation is not only a free-standing dispute resolution technique, but it also can be a useful adjunct to every other dispute control and resolution technique.

A variant of negotiation is the "step negotiation" procedure, a multi-tiered process that can often be used to break a deadlock. If the individuals from each organization who are involved in the dispute are not able to resolve a problem at their level promptly, their immediate superiors, who are not as closely identified with the problem, are asked to confer and try to resolve the problem; if they fail the problem is then to be passed on to higher management in both organizations. Because of an intermediate manager's interest

in keeping messy problems from bothering higher management, and in demonstrating to higher management the manager's ability to solve problems, there is a built-in incentive to resolve disputes before they ever have to go to the highest management level.

Following is a contract clause committing the parties to good faith negotiation:

#### *GOOD FAITH NEGOTIATION*

*The parties will attempt in good faith to resolve promptly any controversy or claim arising out of or relating to this agreement by negotiation between representatives of the parties who have authority to settle the controversy.*

The following paragraphs will implement a step negotiation process:

#### *STEP NEGOTIATIONS*

*If a controversy or claim should arise, the parties will attempt in good faith to resolve any controversy or claim arising out of or relating to this agreement promptly by step negotiations between managers and executives of the parties who have authority to settle the controversy.*

*If the controversy or claim cannot be resolved promptly by the representatives of the parties at the operational level, then \_\_\_\_\_*

*and \_\_\_\_\_ (the middle level managers for each party) will meet at least once and will attempt to resolve the matter. Either manager may request the other to meet within seven days, at a mutually agreed time and place.*

*If the matter has not been resolved within ten days of their first meeting, the managers shall promptly prepare and exchange memoranda stating the issues in dispute and their position, summarizing the negotiations which have taken place and attaching relevant documents, and shall refer the matter to*

*\_\_\_\_\_ and \_\_\_\_\_ (senior executives of each party), who shall have authority to settle the dispute. The senior executives will promptly meet for negotiations to attempt to settle the dispute.*

*If the matter has not been resolved within ten days from the referral of the dispute to senior executives, either party may refer the dispute to another dispute resolution procedure.*

#### **Standing Neutral, Standing Mediator or Standing Arbitrator**

One of the most innovative and promising developments in controlling disputes between parties who are involved in any type of long-term relationship (such as a joint

venture or construction project) is the concept of the pre-selected or standing neutral to serve the parties as a “real time” dispute resolver throughout the course of the relationship. This neutral, or a board of three neutrals (designated variously as a “standing neutral,” “mutual friend,” “referee,” “dispute resolver,” or “dispute review board”) is selected mutually by the parties early in the relationship; is briefed on the nature of the relationship; is furnished with the basic documents describing the relationship; routinely receives periodic progress reports as the relationship progresses; and is occasionally invited to meet with the parties simply to get a feel for the dynamics and progress of the relationship. The standing neutral is expected to be available on relatively short notice to make an expert recommendation to the parties to assist them in resolving any disputes that the parties are not able to resolve themselves. It is important to the effective working of this process that the parties be mutually involved in the selection of the neutral, and that they have confidence in the integrity and expertise of the neutral. Typically the neutral’s role, if called in to help resolve a dispute, is to render an impartial nonbinding recommendation concerning the subject matter of the dispute. In some instances the role of the neutral is changed to be simply a standing mediator to act as an informed facilitator in negotiations between the parties.

Although the standing neutral’s decisions are typically not binding, experience has shown that neutrals’ recommendations have generally been accepted by both parties, without any attempt to seek relief from any other tribunal. This result is enhanced where there is a contract requirement that in the event of any subsequent arbitration or litigation, the recommendation of the standing neutral will be admissible in evidence. Three critical elements are essential to the success of the standing neutral technique:

1. Early mutual selection and confidence in the neutral.
2. Continuous involvement by the neutral.
3. Prompt action on any submitted disputes.

The existence of a pre-selected neutral, already familiar with the business relationship between the parties and its progress, avoids many of the initial problems and delays that are involved in selecting and appointing neutrals after a controversy has arisen. The ready availability of the neutral, the speed with which he or she can render recommendations, and particularly the fact that this neutral will hear every dispute which occurs during the history of the relationship, all provide powerful incentives to the parties to deal with each other and the neutral in a timely and frank manner, by discouraging game-playing, dilatory tactics, and the taking of extreme and insupportable positions. In practice, the nature of this process is such that the mere existence of the neutral always results in minimizing – and often totally eliminating – the number of disputes that have to be presented to the neutral. Even though some expense is involved in the process of selecting, appointing, initially orienting, and periodically reporting to the neutral, the costs are relatively minimal, even when the neutral is called on to resolve disputes.

The standing neutral concept was first used in the construction industry, which has developed standard detailed specifications for the establishment and operation of such a process, using either a group of three neutrals called variously a “Dispute Review Board” or a “Dispute Resolution Board,” or a single “Dispute Resolver.” This process is

readily transferable to other industries. Parties who wish to set up a standing neutral process can refer to such sources as the International Chamber of Commerce (for ICC Dispute Resolution Rules and clauses, see [www.iccwbo.org/court/dispute\\_boards/id4424/index.html](http://www.iccwbo.org/court/dispute_boards/id4424/index.html); for ICC Dispute Board Rules on Dispute Review Boards (DRBs); Dispute Adjudication Boards (DABs); and Combined Dispute Boards (CDBs), see [www.iccwbo.org/court/dispute\\_boards/id4352/index.html](http://www.iccwbo.org/court/dispute_boards/id4352/index.html)), the Dispute Resolution Board Foundation ([www.drb.org](http://www.drb.org)), the American Arbitration Association ([www.adr.org](http://www.adr.org)), or the standard documents of the Federation Internationale Des Ingenieurs Conseils (FIDIC) ([www.fidic.org](http://www.fidic.org)), and adapt the language to the specifics of the particular business relationship or transaction.

In the construction industry the recommendations of a standing neutral are typically merely advisory. However, in certain business contexts the parties may wish to treat the standing neutral's recommendations as binding decisions. In this case the standing neutral becomes a standing arbitrator, and the operative contract language, in addition to providing for the continuing nature of the standing neutral's assignment, should also contain appropriate language that makes the decisions binding under the applicable arbitration statute, and reference the arbitration rules of an established arbitration agency.

Following are typical clauses that parties can use to establish a standing neutral process which can be adapted, as appropriate, to cover the many available roles that a standing neutral can perform.

#### **AGREEMENT FOR STANDING NEUTRAL**

*The parties will, either in their contract or immediately after entering into their contractual relationship, designate a Standing Neutral who will be available to the parties to assist and recommend to the parties the resolution of any disagreements or dispute which may arise between the parties during the course of the relationship.*

**Appointment.** *The neutral will be selected mutually by the parties. The neutral should be experienced with the kind of business involved in the parties' relationship, and should have no conflicts of interest with either of the parties.*

**Briefing of the Neutral.** *The parties will initially brief the neutral about the nature, scope and purposes of their business relationship and equip the neutral with copies of basic contract documents. In order to keep the neutral posted on the progress of the business relationship, the parties will furnish the neutral periodically with routine management reports, and may occasionally invite the neutral to meet with the parties, with the frequency of meetings dependent on the nature and progress of the business venture.*

**Dispute resolution.** *Any disputes arising between the parties should preferably be resolved by the parties themselves, but if the parties cannot resolve a dispute they will promptly submit it to the neutral for resolution.*

**Conduct of hearing and recommendation.** As soon as a dispute has been submitted to the neutral, the neutral will set an early date for a hearing at which each party will be given an opportunity to present evidence. The proceedings should be informal, although the parties can keep a formal record if desired. The parties may have representatives at the hearing. The neutral may ask questions of the parties and witnesses, but should not during the hearing express any opinion concerning the merits of any facet of the matter under consideration. After the hearing the neutral will deliberate and promptly issue a written reasoned recommendation on the dispute.

**Acceptance or rejection of recommendation.** Within two weeks of receiving the recommendation, each party will respond by either accepting or rejecting the neutral's recommendation. Failure to respond means that the party accepts the recommendation. If the dispute remains unresolved, either party may appeal back to the neutral, or resort to other methods of settlement, including arbitration (if agreed upon by the parties as their binding method of dispute resolution) or litigation. If a party resorts to arbitration or litigation, all records submitted to the neutral and the written recommendation will be admissible as evidence in the proceeding.

**Fees and expenses.** The neutral shall be compensated at his or her customary hourly rate of compensation, and the neutral's compensation and other reasonable costs shall be shared equally by the parties.

**Succession.** If the neutral becomes unable to serve, or if the parties mutually agree to terminate the services of the neutral, then the parties will choose a successor Standing Neutral.

\* \* \*

[The language above outlines the most basic kind of Standing Neutral arrangement. If the parties have any special wishes concerning the Standing Neutral's role, or any special procedures that they wish to follow regarding referral of disagreements or disputes to the neutral, they can include them at this point in the agreement. If the parties wish to incorporate and adapt a standard set of procedures into the agreement, they can insert the following language, which refers to a standard set of American Arbitration Association Guide Specifications for construction projects (which are available at [www.adr.org/sp.asp?id=28761](http://www.adr.org/sp.asp?id=28761)):

**Reference Procedures.** The procedures for resolution of disputes by the neutral shall in general follow those established by the Dispute Resolution Board Guide Specifications of the American Arbitration Association, dated Dec. 1, 2000, using Section 1.02D, the Alternative Procedure for Selection of a Single-Member Board, substituting "the Standing Neutral" in every place where there is a reference to the Board; treating every reference to "the Contract" as a reference to "the contract relationship between the parties;" and, in every case where there is a reference to such matters as "construction activity," "job site," "plans, specifications, drawings, contract

*documents” or other terms peculiar to the construction industry, applying those procedures to activities under the contract relationship between the parties.*

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## 6. CPR CONSTRUCTION PREVENTION MONOGRAPHS

CPR has recently published three Dispute Prevention Monographs, written by members of CPR's Construction Advisory Committee, on the subjects of three of the most useful dispute prevention techniques developed by the construction industry.

The titles of these Monographs are:

*Realistic Risk Allocation: Allocating Each Risk to the Party Best Able to Handle the Risk*

*Partnering: Aligning Interests, Collaboration, and Achieving Common Goals*

*Dispute Review Boards and other Standing Neutrals: Achieving "Real Time" Resolution and Prevention of Disputes*

Each monograph, in addition to describing exactly how the particular technique has been successfully used to prevent construction disputes, also identifies ways in which the technique can usefully be adapted to prevent disputes in other industries and business relationships.

Practitioners who wish to know more about the origins, development and nuances of these three important techniques for dispute prevention, control and early resolution will find these monographs to be a rich source of information.

## 7. BACKGROUND PAPERS, RESEARCH STUDIES AND EXPLORATORY MATERIALS

As a by-product of the CPR Prevention Exploratory Group's research work, the group generated and identified a number of background papers, research studies and exploratory materials, most of which are still works in progress. These materials could well benefit from the comments and ideas of researchers and scholars in the field, so CPR has determined that they should be made available for examination and revision. Following is a partial list of such materials, copies of which may be obtained or accessed by interested individuals by contacting the CPR Library.

*An overview of the present state of the art and practice of anticipation and prevention of disputes around the world.*

*A Webliography of prevention materials (authored by Helena Haapio of the ProActive ThinkTank)*

*Language and expressions describing the practice of anticipation and prevention.*

*A preliminary inventory of various sources and subjects of business disputes.*

*Thoughts on recent evolutionary changes in the disputes field, and the resistance that some of these changes have experienced.*

*Thinking Ahead: Moving from Reactive Dispute Resolution to Proactive Dispute Anticipation and Prevention (the Report of the CPR Conflict Prevention Exploratory Committee).*

*The economic case for preventing and controlling disputes.*

*Methods of implementing, training, evaluating, and measuring prevention practices.*

*Implementation materials such as: (1) The natural constituency for dispute prevention: business leaders, managers, and their inside counsel. (2) The economic case for preventing and controlling disputes. (3) Methods of implementing, training, evaluating, and measuring prevention practices.*

*Study project: The problem of "internal integration" of participants who may be confronted with special emergencies such as aviation emergencies and healthcare emergencies: The need for anticipating and dealing with such emergencies and the importance of special advance training*

*Research inquiry: Why are business leaders so willing to fund dispute resolution efforts but reluctant to fund dispute prevention efforts? Is it because dispute resolution is tangible, something they can feel and touch, while dispute prevention, whose objective is to create "non-events," is intangible, less real?*

*Research inquiry: To what extent have there been studies about the behavior of parties to a business relationship when they are confronted with an unexpected event, emergency, or problem?*