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The Standing Neutral—Low-Cost Insurance to Prevent Disputes on Construction Projects

By Margaret "Peggy" Landry and James P. Groton – May 30, 2014

Construction is a high-risk business, often volatile, with a high potential for problems and adversarial relationships. Every project involves a multitude of participants—an owner, a design and engineering team, many members of a construction team—all with potentially conflicting interests, working on a critical path, with a shared goal to complete the project on time and under budget. Once the work begins, the project cannot be interrupted or delayed to any extent without serious repercussions. This is why the construction industry places a premium on resolving problems quickly.

At the beginning of a project, the participants are generally optimistic about reaching their goals and typically underestimate the potential for conflict. They often think, "What can happen?" But the reality is that all too frequently communications break down, the construction plans have omissions, the weather is inclement, materials don't arrive, and subcontractors default. Each of these unplanned events, if not quickly solved or properly controlled, could result in a dispute that can escalate to the point where it could disrupt the project and cause the project to unravel, embroiling the parties in expensive discovery, mediation, arbitration or litigation, and ultimately lost business relationships.

In the business world it's prudent and customary to buy commercial insurance to protect against the adverse consequences of all kinds of risks and potential losses, and it's also quite common for participants on construction projects to obtain surety bonds. Virtually all business people consider the premiums they pay for business insurance and surety bonds to be a good return on investment, even if the risks that are insured against never occur.

How can participants in a construction project protect themselves against the risks and adverse consequences of disputes in the all-too-common scenarios described above? Unfortunately, there is no commercially available insurance market that will provide protection against the risks of disputes from unknown project problems. However, there are prudent steps that construction project participants can take, comparable to (and probably less expensive than the combined premiums on) insurance and surety bonds, which are likely to protect against those risks. All that is required is to make a modest investment to use proven processes that keep unforeseen project problems from escalating into harmful disputes.

One of the most promising developments for controlling the risk of disputes on a construction project is the "standing neutral" process—the concept of preselecting a respected neutral expert, or panel of experts, to be a dispute resolver throughout the life of the project. Employing a standing neutral has achieved remarkable success in keeping disputes that arise during construction from disrupting the schedule and the budget. In fact, the statistics show that just having a neutral can actually prevent disputes from occurring throughout the entire construction. It has an added benefit of creating harmonious relationships among the contracting parties.

Even though it has proven itself wildly successful and the cost is negligible in the context of total project costs, the use of the standing neutral, although growing in the industry, has not yet been widely embraced and used as a conventional risk-management tool in the same way that surety bonds and insurance are used today.

This article first describes the standing neutral process. Then, the article reports on the considerable success of projects that have employed a standing neutral, and gives a real-life example of its effectiveness and its relatively low cost. Last, it makes suggestions on how to motivate the construction industry to embrace and use this technique as a conventional risk-management tool in the same way commercial insurance and performance bonds are currently used.

The Standing Neutral Process

At the very beginning of construction, the owner and contractor select by mutual agreement a respected neutral expert in whom they have confidence to be readily available to assist the parties throughout the project, to provide real-time expert recommendations on any problem that might occur during the construction. To be effective, the neutral should be known to and respected by the parties. On large construction projects, the standing neutral is often not just one person but a three-person dispute resolution board (DRB), all of whom are experts in the construction field. In this case, each party selects

one neutral, and then the two neutrals select the third. The parties generally share the cost of the neutral.

After being selected, the neutral is thoroughly briefed on the project and issued a set of the project's contract documents, including the drawings and the specifications. The parties periodically inform the neutral about the project's progress through written reports. The neutral will usually attend monthly construction meetings to be familiar with the current issues and to be able to anticipate any potential future issues. If a dispute arises, parties will promptly request the standing neutral to hear the matter through an informal process. The standing neutral's strength in the process is that the neutral is available on relatively short notice to evaluate an issue and make a quick recommendation on how to resolve the problem so that the project will not be delayed.

Typically, the neutral's decision is nonbinding, but experience has shown that routinely both parties accept the neutral's recommendation as a basis for solving the issues presented. Because the neutral is an expert selected by the parties, his or her opinion is valued, and so the neutral's recommendations are often a "dose of reality" that one or both of the parties need in order to evaluate the problem and to become more objective in negotiating a resolution. When a problem is quickly resolved, it helps to prevent any one issue from snowballing into something bigger than it needs to be or generating other issues. This approach provides a cooperative environment.

Statistics and well-documented reports on the business relationships in which construction projects have used standing neutrals reveal that when a standing neutral is available, the parties submit relatively few disputes to the neutral. In most cases, the parties have resolved all of the problems themselves without ever referring any dispute to the neutral.

The result of the process is that what initially appears on the surface to be an effective alternative dispute "resolution" process is actually a remarkably effective dispute "prevention" technique. Apparently, just having the neutral on the team promotes cooperation and actually provides incentives for the parties to resolve their problems among themselves without involving the neutral.

Empirical Data

The standing neutral process has been in use for more than 35 years. Today there is a great deal of empirical evidence that this process works remarkably well in the construction industry. The [Dispute Resolution Board Foundation](#) (DRB Foundation) is a nonprofit organization dedicated to promoting the avoidance and resolution of disputes worldwide using the unique and proven DRB method. A database of more than 1,200 projects that used DRBs presented the following results:

- 58 percent of the projects were "dispute free," with no disputes submitted to the DRB;
- 98.7 percent of the disputes that were submitted to a DRB for hearing resulted in settlement of the dispute with no subsequent litigation or arbitration; and
- most of the small handful of cases in which a party challenged a DRB decision in arbitration or litigation were either not pursued to conclusion or failed.

DRB Found., [DRBF Practices and Procedures](#), last accessed on May 20, 2014.

These are amazing statistics that need to be recognized for their value in preventing disputes by the industries that influence and control aspects of the construction industry, specifically the lenders who finance construction projects, the sureties who issue performance bonds, and the owners and public bodies who build buildings, roads, and bridges.

The DRB Foundation also [provides statistics](#) showing how inexpensive the cost of a standing neutral is, particularly when compared with the expense and delays of mediation, arbitration, and litigation. DRB members typically charge an hourly rate commensurate with their experience. The total costs for a three-member DRB have ranged from about .05 percent of final construction costs for a relatively dispute-free project, to about .25 percent of final construction costs for a more active dispute process.

In 1991–1992, a coauthor of this article conducted a study of a three-member DRB in connection with the construction of a \$20 million office building near Atlanta. The DRB met for half a day at the construction site every two months and received monthly progress reports and photos. There were several problems on the project, but the parties—fully aware that the DRB was monitoring their behavior and was ready, willing, and able to resolve any problem that the parties themselves were unable to resolve—managed to resolve all potential disputes on the project, so it was not necessary for them to refer any problems to the DRB. The total DRB cost was \$7,000 or .04 percent of the construction cost. Robert. M. Matyas et al., *Construction Dispute Review Bd. Manual* 107 (1996).

Based on the cost statistics of the DRB Foundation, having a standing neutral appears to be the best dispute preventer that money can buy on most construction projects.

Motivating Conventional Use of Standing Neutrals

Clearly, the standing neutral has proven to be an invaluable dispute preventer—a true "ounce of prevention" in the construction industry. Nonetheless, it is not gaining the momentum it deserves. The question now is how to motivate the construction industry more widely to embrace the concept of the standing neutral and have the neutral's service become a conventional risk-management (or risk-aversion) tool—just as surety bonds and insurance are currently used as conventional risk-management tools on typical construction projects?

Perhaps the motivation needs to come from outside influences. One suggestion is to lobby and educate the institutions that influence and control varying aspects of the construction industry, such as the surety industry, lending institutions, and the various public entities that build public works, about the remarkable value the standing neutral brings to a project

in deescalating and preventing disputes, thereby reducing the risk of default on a project. The DRB Foundation and its members could be a leading force to help advise the lending, surety, and other public institutions of the value of the standing neutral as a required component of a construction project when there is a construction loan and or performance bond on the project.

One target of influence could be the lender. The lender loans money to an owner or developer to purchase property and build projects. During the underwriting process of the construction loan, the lender evaluates the risk of a project's success. It's the risk of default of the developer that the lender is concerned with in evaluating whether the developer will get a loan. The developer's success is partly a function, however, of the contractor's success. If the lender understands the value of a standing neutral's role in eliminating disputes on a construction project, perhaps it would be motivated to require it as a condition precedent for the developer to qualify for the loan, just as lenders often require the contractor to carry a payment bond and builder's risk insurance.

Another target could be the surety industry. A surety company issues a performance bond to guarantee that the project will be completed in the event a contractor defaults. Surety companies spend a great deal of time and expense in the underwriting process to qualify a contractor before issuing a surety bond. Surety company underwriters evaluate risk much in the same way as banks evaluate loan applications, during which the surety is looking at the company's resources, its loss history, management skills, credit reports, expertise, experience, equipment, and the type of construction project the bond is covering. If the surety considered the low cost and high success of a standing neutral's role in eliminating disputes on a construction project, thus reducing the risk of contractor default and closing out the project earlier, perhaps it would require it as a condition precedent for issuing the bond, just as sureties require the contractor to carry a certain amount of insurance.

A third target could be the various public entities that build public works. Public-works projects usually require hiring the lowest bidder on a project. Most public-works project owners also require a contractor to post a performance bond. Having the performance bond will make sure the project is completed, but it does not guarantee it will be completed on time, which may be fundamental to the success of a project. As discussed throughout this article, having a standing neutral on a project tends to dramatically reduce disputes and creates cooperation among the parties. When there are fewer disputes and a more cooperative environment, the contractor is less likely to default because of unresolved disputes that disrupt the schedule. To protect the public from defaulting contractors who may disrupt a project's schedule, all public entities (just as the hundreds of entities whose projects have been documented in the DRB Foundation database) should require a standing neutral as part of their risk-management plan.

Conclusion

The standing neutral is a risk-management tool that has been underappreciated for too long. The favorable return on investment in having a standing neutral to eliminate the risk of disputes on a construction project has been well documented during the past 35 years. Today it should be just as prudent for the sponsors of construction projects to employ a standing neutral as it is for them to buy performance bonds and commercially available insurance.

Keywords: litigation, commercial, business, standing neutral, dispute resolution boards, Dispute Resolution Board Foundation, risk management, construction projects, dispute prevention

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