Construction

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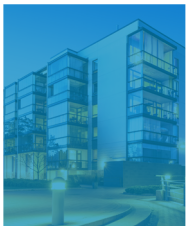
CONSTRUCTION BULLETIN





Welcome to the March edition of our Construction Bulletin

In this edition we cover a broad range of contractual and legal issues relevant to the construction industry:

- **Project insolvency and choice of jurisdiction:** Following project insolvency, some debtor companies have successfully sought the protection of foreign debtor-friendly jurisdictions like the United States, despite having only very limited connections to that jurisdiction. However, as David Ulbrick writes, a recent case in the United States and pending changes to EU regulations mean that this tactic could be less successful in the future.
- **Arbitration in Saudi Arabia:** Robert Blundell covers developments in Saudi Arabia that have the potential to make arbitration a more attractive means of dispute resolution in that jurisdiction.
- **Landmark UK case on liquidated damages:** In different jurisdictions around the world, including in the Middle East, courts will sometimes invalidate a contractual clause because it is in law a penalty. Katherine Doran discusses a recent UK Supreme Court decision restating the English penalties doctrine, and identifies a divergence between the development of the law in the UK and Australia.
- **FIDIC Middle East conference:** The 2016 FIDIC Middle East Contract Users Conference was held in Dubai in mid-February. Michael Sergeant attended and here he provides an insight into the major topics of discussion, including the revisions to the FIDIC suite of contracts currently being considered which will have implications for projects in the Middle East and across the globe.

The inside back page of this Bulletin contains a listing of the events at which the members of the HFW construction team will be speaking over the coming months.

Should you require any further information or assistance with any of the issues dealt with here, please do not hesitate to contact any of the contributors to this bulletin, or your usual contact at HFW.

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Project insolvency and choice of jurisdiction

High profile insolvencies in the construction industry highlight the risks faced by contractors, and also the way in which debtor companies can seek to obtain advantage through 'forum shopping' once insolvency occurs, by seeking to invoke the jurisdiction of debtor-friendly countries like the United States.

In the last few years there have been some high profile losses made on construction projects in the energy and resources sector, highlighting the financial risk that a contractor takes on from the moment that earthworks commence. A contractor's broader corporate group will often have the balance sheet to ride out the loss. However, this isn't always the case.

As contractors become increasingly global in their reach, the 'ripple effect' of an insolvency event on one project can have far reaching consequences. This is particularly so in the construction industry where the proportion of insolvencies derived from the industry (between 20 and 25% in Australia, approximately 23% in Scotland and 15% in England and Wales) is out of proportion to the broader economic contribution of the industry.

Take, for example, the development of the Baha Mar resort in The Bahamas. The project is a 3.3 million square foot resort complex located in Cable Beach, Nassau, The Bahamas. With a reported project cost of US$3.5 billion the project was supposed to add 12% to The Bahamas' GDP[1].However, despite being 97% complete, work on the project has stopped and it has become the "world's biggest white elephant" as claims and bankruptcy proceedings wind their way through the project's DRB and courts in The Bahamas, Delaware and London.

There are multiple reasons for why the parties have started proceedings in different forums. One obvious reason is that different contracts associated with the project are subject to laws of different jurisdictions. A less obvious reason is the various ways in which different jurisdictions treat insolvent debtors. It was for this reason that the debtor companies in the Baha Mar case sought the protection of the US Chapter 11 provisions.

In order for the claim to come within the jurisdiction of the US, each of the debtors opened up bank accounts in Delaware in June 2015 and deposited a mere US$10,000 on the basis that this would be enough to allow them to claim Chapter 11 protection. The debtors' tactic relied on a line of authority which held that the requirement that there be "property in the US" was satisfied even where there was only minimal property. However, Judge Carey in the Delaware District Bankruptcy Court was not swayed. He held that (for all but one of the debtor companies) the insolvency proceedings would take place in The Bahamas because it was obviously more closely related to the project than the presence of a small amount of money in a US account.

In the current economic climate it seems almost inevitable that insolvencies in the construction industry (including in large scale international projects) will continue to rise, leading to choice of jurisdiction issues. Factors that might influence a choice of jurisdiction might be whether the jurisdiction offers alternatives to liquidation, whether there are specialist courts and "fast track" processes in place to speed the restructuring process, or even the consequences for individual directors in relation to insolvent trading[2]. However, regardless

It seems clear that last minute efforts to fall into a debtor-friendly jurisdiction will not always be successful.

DAVID ULBRICK, SPECIAL COUNSEL

of the factors influencing the choice it seems clear that last minute efforts to fall into a debtor friendly jurisdiction will not always be successful. This is particularly so in the EU where forthcoming reforms to the Insolvency Regulation (EC) 1346/2000 (taking effect on 29 June 2017) will require decision makers to carefully investigate changes to a debtor's "centre of main interest" in the three months prior to the insolvency proceedings commencing. Of course, this will not prevent parties to construction projects who are having solvency issues from trying. So if your subcontractor suddenly moves its project office to a different jurisdiction or asks you to deposit the next payment into a bank account in the US it might be time to start asking questions about their solvency position and taking steps to protect your project.

For more information please contact David Ulbrick, Special Counsel, on +61 (0)8 9422 4701, or david.ulbrick@hfw.com, or your usual contact at HFW.

1 In re Northshore Mainland Services Inc (Bankr D Del, 15-11402, 15 September 2015) slip op 5 (Carey J).

2 See, for example, the Australian Corporations Act 2001 (Cth) s 588G.



Arbitration in Saudi Arabia

Historically, both litigation and arbitration have been regarded as unattractive methods of dispute resolution by overseas parties operating within the Kingdom of Saudi Arabia (KSA). However, recent developments within KSA coupled with a changing economic environment have led to more parties investigating arbitration to resolve disputes.

Despite the existence of a well-qualified and consistent judiciary, the KSA courts have been an unpopular route for the resolution of disputes in the past. This is largely due to foreign parties' concerns about a prohibitive bureaucracy and fear of local respondents having a 'home advantage'.

Until recently, the establishment of international arbitration in KSA has also been problematic for a number of reasons.

KSA courts previously had to approve arbitration procedures prior to their initiation which effectively operated as a block on submitting proceedings. The courts also previously had the power to ratify the appointment of arbitrators, and this would effectively permit a responding party to obstruct a dispute by simply refusing to participate.

Once a tribunal was formed outside KSA, any award would then be subject to a fresh review by local courts which would then frequently apply the principles of KSA law to the substance of the dispute, effectively re-hearing the matter.

Shari'a law applies in KSA, and such principles include the enforcement of arbitral awards. As a result, a foreign award would be prevented from enforcement where non-compliant aspects of a contract (such as interest payments) would be reassessed locally.

New rules were introduced to actively support the use of arbitration within KSA... requiring the courts to give priority to the arbitration rules chosen by the parties.

ROBERT BLUNDELL, PARTNER

In 2012, to address the various procedural problems, new rules were introduced to actively support the use of arbitration within KSA. These rules effectively swept away the restrictions outlined above, requiring the courts to give priority to the arbitration rules chosen by the parties.

Compliance with Islamic shari'a is still required at all stages, but it is now not possible for the court to deviate from either permitting an arbitration to continue or from enforcing an award. Further minor positive changes were also introduced, such as the permission to carry on the proceedings in a language other than Arabic.

It must be borne in mind that arbitration of itself does not conflict with the principles of shari'a. However, parties seeking to arbitrate must still provide the appropriate safeguards that the principles of shari'a are not only upheld by the laws that apply to the matter subject to arbitration, but that such principles are seen to underpin any arbitral procedures that are adopted.

This could still have a far-reaching effect. For example shari'a law could rule against enforcing interim applications as the inability of a party to be able to present a case in full may be regarded as rendering an award unlawful. It may also impact upon more prosaic matters such as invalidating expert testimony not given under a binding oath.

The choice of English law, for example, would not be automatically non-compliant, but there remains an opportunity for matters to be challenged if either the law or the principles of the contract are not compliant. Parties would be wise to choose the law of KSA (or at least another GCC country) to apply to the contract in the first place to avoid such concerns.

A significant step to overcoming the remaining procedural hurdles to arbitration in KSA was announced in 2014 with the establishment of the Saudi Centre for Commercial Arbitration (SCCA). When it comes into formal operation it is widely anticipated that a dedicated centre of expertise will provide a suitable forum where the 'pinch points' mentioned above will be dealt with.

The SCCA would be able to ensure that the tribunal would always possess the requisite skills for compliance with law, such as the requirement that at least one tribunal member should hold a degree in Islamic legal studies.

Until such time as the SCCA comes into operation, parties should ensure arbitration clauses are drafted to ensure that procedures are compliant with local law. This will provide a much greater degree of confidence in the enforceability of any award.

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Landmark UK case on liquidated damages

Many legal systems worldwide will not enforce contractual provisions which are penalties. However, the courts' desire to enforce parties' commercial bargains has led to inconsistent application and tortuous interpretation of the rule against penalties. The UK Supreme Court's decision in *Cavendish v Makdessi* and *ParkingEye v Beavis* has provided clarity in this area.

In construction contracts we commonly encounter the rule against penalties when considering liquidated damages (LDs) clauses.

LDs provide that on certain specified breaches of contract (for example, failure to complete the works on time), a pre-determined sum of money is paid by the defaulting party to the innocent party. LDs are an alternative to general damages, which require proof and quantification of actual loss, which can be time consuming and complex. In most cases LDs can be deducted from monies otherwise due to the defaulting party without the need for formal dispute resolution procedures.However, LDs clauses which are penalties will be unenforceable.

Historically, the main factor in determining if LDs were a penalty was whether they represented a genuine pre-estimate of loss, or if the purpose of the clause was to serve as a deterrent.

A similar principle applies in many Middle Eastern legal systems. For example, the UAE Civil Code permits courts to adjust LDs to reflect the actual loss suffered.

The difficulty is, concepts of "pre-estimates of loss" or "penalties" are not necessarily mutually exclusive.

Cavendish Square Holding BV v Talal El Makdessi

Mr Makdessi agreed to sell Cavendish a controlling stake in the holding company of the largest advertising and marketing communications group in the Middle East.

Cavendish sought to protect its interest by including provisions preventing Makdessi from competing with it. If Makdessi breached these restrictive coventants (a) he would not receive two final instalments of the purchase price; and (b) he would have to sell his remaining stake in the company to Cavendish at a value excluding goodwill.

Makdessi admitted breach of the restrictive covenants, but argued that the clauses in question were penalties and therefore invalid. He argued that the effect of the clauses would preclude him from receiving significant sums of money (up to US$44 million) and force him to transfer his shares at an undervalue. Makdessi said neither of the clauses in question represented a genuine pre-estimate of loss, since it was unlikely that Cavendish's losses – if quantifiable – would have been anything close to US$44 million.

At first instance, the court held that neither clause was a penalty, since they were commercially justifiable. The Court of Appeal, however, found that they were penalties, since they were "extravagant and unconscionable".

Abolishing or extending the rule against penalties?

The Supreme Court was not prepared to abolish the rule against penalties as it is a long standing principle of English law, and common to almost all major systems of law.

For example many Middle Eastern legal systems permit the courts to adjust LDs clauses in contracts to achieve the shari'a principle of fairness. Under the Qatari Civil Code the courts have discretion to reduce the rate of LDs which are found to be grossly excessive.

The Supreme Court also declined to extend the rule against penalties, as the High Court of Australia recently did in *Andrews v ANZ* (2012). In that case, the court relied upon the rules of equity to offer relief from bank charges levied in response to account "irregularities" (which did not amount to breaches of contract), and held the charges could potentially amount to penalties.

The Supreme Court did not follow the Australian approach in *Andrews v ANZ,* holding that such inroads into freedom of contract should not be extended by judicial, as opposed to legislative decision making.

Types of clauses

The Supreme Court declined to restrict the rule against penalties to clauses that required the defaulting party to pay money, as opposed to clauses that in the same circumstances allowed the innocent party to withhold moneys which were otherwise due.

The court accepted that withholding clauses were capable of falling within the penalty doctrine, but they will not always amount to penalties. That depends on the nature of the right which the defaulting party is being deprived of, and the basis for depriving him of it.

However, the court was of the view that clauses which related to the build up of the contract price were primary obligations, rather than secondary obligations, which only operate on breach of a separate primary obligation. As such, the penalty doctrine would not bite where not all of the contract price was payable because a particular obligation had not been met.

The proper test for a penalty

The court stated that the law in this area had, in the past, been dominated by the artificial categorisation of mutually



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KATHERINE DORAN, ASSOCIATE

exhaustive concepts of genuine pre-estimates of loss and deterrence. However, not all clauses obviously fall within this dichotomy.

The lower courts have tried to avoid this by developing a "commercial justification" test – in other words even if a clause did not represent a genuine pre-estimate of loss, did it nevertheless have a commercial justification? The Supreme Court rejected this approach, since it is questionable that a provision cannot be a deterrent if it also had a commercial justification.

The Supreme Court did, however, accept that a clause operating on breach (like LDs) could be justified by considerations other than monetary compensation. Therefore, even if LDs are not a genuine pre-estimate of loss the clause will not necessarily be a penalty. Deterrence is not important. The real question is whether the clause is a secondary obligation which imposes on the contract-breaker a detriment out of all proportion to any legitimate interest of the innocent party, in the enforcement of the primary obligation.

In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach.

Application of the test: *Cavendish v Makdessi*

The clauses in question were held to protect the legitimate commercial interests of Cavendish – protection of goodwill. Neither was concerned with the measure of compensation for breach. Although the clauses were intended to deter breach, they nevertheless had a legitimate function that had nothing to do with punishment, and everything to do with achieving Cavendish's commercial objective. In any event, the clauses in question were primary obligations, concerned with the build up of the contract price, and as such, the penalty doctrine was not engaged.

ParkingEye v Beavis

ParkingEye manages a car park which displays notices stating that overstaying the two hour time limit would result in a charge of £85. Billy Beavis parked in the car park for almost three hours. ParkingEye demanded the £85 charge, but Mr Beavis refused to pay on the basis that it was an unenforceable penalty. The court at first instance and the Court of Appeal both rejected Beavis' arguments.

ParkingEye conceded that £85 was not a genuine pre-estimate of its losses. Because ParkingEye managed, rather owned the site, it would be hard to argue it had lost anything through Beavis overstaying his allotted two hours.

The Supreme Court found that the charge was not a penalty. The court found that the charge had two main objects. The first was to manage the efficient use of parking spaces, by deterring long stay parking. The other was to provide an income stream to enable ParkingEye to meet the cost and obtain profit from the scheme.

The court found that deterrence is not penal if there is a legitimate interest in influencing the conduct of the contracting party, which is not satisfied solely by recovery of damages.

Of course, ParkingEye could not charge overstayers an amount which would be out of proportion to its interests. However, on the evidence, the £85 charge was not found to be disproportionate.

How has the law changed in England?

Since the Supreme Court's ruling the test of whether a clause is a penalty is (1) does it protect a legitimate interest? and if so (2) is the clause nevertheless extravagant and unconscionable?

For simple LDs clauses in standard contracts the answer to these questions might be whether the clause is a genuine pre-estimate of loss. But that does not solve more complex cases, or cases where parties to an agreement have commercial interests which go beyond mere monetary compensation.

Financial compensation is not the only legitimate interest that parties may have. Properly advised parties of equal bargaining power are presumed to be the best judges of what is legitimate.

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FIDIC Middle East Conference

HFW sponsored FIDIC's annual Middle East Contract Users Conference this year which took place in Dubai on the 16 and 17 February. The event was a great success, allowing delegates to exchange experiences on international projects, as well as providing an update on the on-going process of updating the FIDIC suite of contracts.

The FIDIC forms of contract are probably more widely used in the Middle East than anywhere else in the world. As such, this annual conference is a key forum for an exchange of views on how the FIDIC contracts are coping with the challenges that arise on large modern projects. As always, the conference attracted a wide range of delegates from a variety of backgrounds which ensured an excellent standard of informed debate.

Update of FIDIC contracts

FIDIC has, over the last few years, been undertaking a review of its suite of contracts that were last updated in 1999. The review is beginning to advance towards some final conclusions with a view to publication of the new suite later this year.

The strategy adopted by the drafting committee is to concentrate first on the Yellow Book, on the basis that if a final consensus on changes to this form can be finalised then changes to the other contracts will follow. A current revised draft of the Yellow Book was issued to a hand-picked cross-section of users towards the end of 2015 for what has been termed a "friendly review".

One of the keynote talks of the conference was given by drafting committee member Siobhan Fahey, providing an update to the conference on the contract review process.

This annual conference is a key forum for an exchange of views on how the FIDIC contracts are coping with the challenges that arise on large modern projects.

MICHAEL SERGEANT, PARTNER

Siobhan outlined a number of changes to the Yellow Book that are currently under final consideration as part of the friendly review process.

A number of the proposed changes are focussed on enhancing the project management tools and mechanisms under the contract. These include plans to give more certainty to the contractual notice procedures by stipulating with more precision the form that a notice needs to take. In addition, there are plans to beef up the requirements for the provision of supporting particulars following a notice.

Other proposed changes are focussed on the contractual disputes procedures. For example, by splitting the matters currently covered by clause 20, so there are clear and distinct clauses for both claims and disputes. The aim is to encourage the parties to treat claims in a less adversarial way and to recognise that a claim involves the triggering of entitlement as a result of the parties' risk allocation, and therefore not something that should necessarily lead to a dispute.

Other conference themes

A number of key themes arose from a number of presentations at the conference. There were a number of talks about variations, which is always an especially important topic in the region. This included a talk on how variations compare to claims (via clause 20) under the FIDIC contracts and the degree to which a contractor may be able to choose between these two possible routes for compensation. This is an issue of particular importance under the FIDIC forms because claims are subject to tight notice periods under clause 20, whilst variations do not require service of a notice and therefore, in this sense, cannot become time barred.

There were also a number of talks in relation to the disputes processes that can be followed under the FIDIC forms. Of particular interest was the DAB process under FIDIC, not least because this is one area that is up for review as part of the contract re-drafting process. A number of speakers discussed the comparative benefits of having a DAB that will give a binding decision as opposed to an advisory recommendation to the parties. The conference closed with a panel discussion about dispute processes with a particular focus on arbitration.

This is the second year running that HFW has sponsored the FIDIC Middle East conference and we have found it a truly interesting and informed forum for debate. HFW has recently opened three new offices in the region, in Riyadh, Beruit and Kuwait. Therefore, for us to be involved in the region's premier construction law conference fits neatly into the ambitions for our developing team.

For more information please contact Michael Sergeant, Partner on +44 (0)20 7264 8034, or michael.sergeant@hfw.com, or your usual contact at HFW.



Conferences and events

Society of Construction Law
Variations and Claims: options available to a contractor as to how it claims compensation for changes
Tunbridge Wells, United Kingdom
1 March 2016
Presenting: Michael Sergeant

Lighthouse Club Australia (Melbourne Chapter) Networking Event
Melbourne
10 March 2016
Attending: Nick Longley

HFW Seminar: Ethics in Contract Management
Perth, Australia
15 March 2016
Presenting: David Ulbrick

Resolution Institute's Seminar Series
An introduction to arbitration presented by external speaker Neil Kaplan
HFW Melbourne office
16 March 2016
Hosting: Nick Longley

Mixed-Use Development Australia
Legal risks and responsive sales & leasing mechanisms in mixed-use projects
Melbourne
16-17 March 2016
Presenting: Carolyn Chudleigh

HFW Seminar: Insolvency in the Construction Industry
Perth, Australia
22 March 2016
Presenting: Matthew Blycha

EPC Contracts Seminar
Seoul, Korea
26 April 2016
Presenting: Max Wieliczko and Nick Longley

Agribusiness Law in Australia and Asia-Pacific
Legal issues regarding foreign investment in Australian agricultural land and rural industries
Gold Coast, Australia
5-6 May 2016
Presenting: Carolyn Chudleigh

University of Melbourne, Melbourne Law Masters Programme
Managing Legal Risk in Construction
Melbourne
11-17 May 2016
Presenting: David Ulbrick and Nick Longley

Construction Law Seminar
Arbitration update in the Gulf Co-operation Council (GCC)
The Palace Hotel, Dubai
17 May 2016
Presenting: Robert Blundell and Max Wieliczko

5th Annual Subsea Power Cables Conference
London
17-18 May 2016
Presenting: Richard Booth

2nd Annual Qatar International Arbitration Summit
Qatar
18 May 2016
Presenting/Attending: Damian Honey and Michael Sergeant

HFW Construction Law Seminar
Variations Workshop
HFW Melbourne office
22 May 2016
Presenting: Nick Longley and Brian Rom

HFW Quarterly Construction Seminar
HFW London office
24-25 May 2016
Presenting: Max Wieliczko, Richard Booth and Katherine Doran

MBL Construction Law Conference
Options for additional payments: variations and "claims" compared
London
14 June 2016
Presenting: Michael Sergeant

HFW Procurement Seminar
HFW London office
July 2016
Presenting: Anthony Woolwich and Richard Booth

HFW Construction Law Seminar
Construction Insurance Claims
HFW Melbourne office
18 August 2016
Presenting: Nick Longley

HFW Construction Law Seminar
Construction Law: 2016 in Review
HFW Melbourne office
17 November 2016
Presenting: Nick Longley

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