The Asia-Pacific Arbitration Review

2021

Disputes in construction and infrastructure projects
Across 17 chapters and 112 pages, The Asia-Pacific Arbitration Review 2021 offers an invaluable retrospective. Together, our contributors capture and interpret the most substantial recent international arbitration events of the year just gone, with footnotes and relevant statistics. Other articles provide valuable background so that you can get up to speed quickly on the essentials of a particular country as a seat. This edition covers Australia, China, Hong Kong, India, Japan, Korea, Malaysia, Singapore and Vietnam. It also has overviews of construction and infrastructure disputes in the region (and how to avoid them), investment treaty arbitration (particularly its relevance to the Belt and Road Initiative), the impact of covid-19 on the art of damages calculation, and third-party funding. Among the nuggets it contains: the common mistakes that contractors make when allocating risk in contracts and how to avoid them; a groundbreaking year for international arbitrations in Korea; the vogue among Asian states for including appeal mechanisms in their ISDS; how China’s government has managed to open up the mainland market to institutions such as the ICC, without having to amend the national arbitration law; the end of natural-justice based challenges to awards in Singapore; and a handy table showing the position of third-party funding in eight Asian states.
Disputes in construction and infrastructure projects

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IN SUMMARY

Parts of the Asia-Pacific region have experienced significant economic growth in recent years. This growth has fuelled extensive infrastructure development, particularly in the Association of Southeast Asian Nations region. Bodies such as the Asia Development Bank predict that significant investment in regional infrastructure development will be needed in the coming decade and investors (eg, multilateral development banks and Chinese state-owned enterprises under the Belt and Road Initiative) have the resources (and the intention) to invest in these projects.

Complex international infrastructure projects lead to complex disputes. In disputes within the region, issues often arise when inbound foreign investors are unfamiliar with the host country's legal landscape, engagement with state parties and security, and fail to take steps to mitigate risks. This chapter discusses these issues and proposes some practical steps that could be taken to avoid risks.

DISCUSSION POINTS

• With rising economic growth and increasing energy needs, infrastructure will continue to be a focal point in the next decade.

• Project companies need to be able to manage relationships with multiple stakeholders – governments, multilateral development banks and state-owned enterprises will all play a pivotal role.

• International infrastructure projects involve significant risks and it is imperative that steps are taken at the time of contracting to appropriately assess their potential impact and mitigate them. Failing to do so will increase the prospect of construction disputes, which are commonly resolved in the Asia-Pacific region by international arbitration.

The Asia-Pacific comprises 47 diverse countries – from the developing mountainous state of Nepal, to developed continental Australia. Each has its own unique and nuanced cultural, legal, social and economic landscape. Parts of the region have experienced substantial economic growth in the past decade. Alongside an ever-increasing population, this will continue to generate demand for new infrastructure. According to the Asia Development Bank (ADB), developing Asia will need US$26 trillion investment for infrastructure development between 2016 and 2030.

In Asia, many of the projects on the horizon are for the development of state-planned – although not necessarily state-owned – civil infrastructure, primarily in the energy, water, waste and transportation sectors. In addition to traditional state funding, these projects are increasingly funded using complex equity and debt financing arrangements. Regional and international multilateral development banks (eg, the Asia Infrastructure Investment Bank and the ADB), and state-backed export-import banks, each with broad investment mandates, continue to play a key role in the development of these projects. In particular, China's role as a major investor, funder and provider of technical expertise and manpower – under the banner of the Belt and Road Initiative (BRI) – will also drive project development. Indeed, the projects that have broken ground in recent years have been overwhelmingly international in
nature, with contractors, technology, equipment manufacturing and financing often coming from outside the host country.

The regional outlook is, however, not entirely positive. Changes in governments driven by socio-economic shifts and increasing resource nationalism have already dampened some regional projects and, at the time of writing, the long-term implications of the covid-19 pandemic are unclear. Trade tensions, particularly between the United States and China, have further impacted on growth and, once again, the long-term implications of these geopolitical events are hard to discern.

With significant sums of money involved, multiple stakeholders and close government scrutiny, complex infrastructure projects in the region (and elsewhere) are a legal minefield. It is, therefore, unsurprising that many large projects give rise to large disputes. A large proportion of these – in particular those arising from international projects – are resolved by arbitration. In this chapter, we take a look at some of the key risks that arise in the context of projects in the region and we recommend some steps that can be taken to mitigate these risks. We finish with some comments on the BRI.

LOCAL LAW RISKS

Any international infrastructure project will involve material engagement with the local legal regime of the place where development is occurring. In the Asia-Pacific region, the laws and cultures of each country vary significantly and may be unfamiliar to foreign inbound investors. This creates risks that need to be addressed in the contracting process, and that can be better addressed the earlier they are acknowledged.

Mandatory Laws

Inbound investors cannot avoid or ignore the local legal landscape of the state in which the project is being constructed. Local laws should be complied with, as non-compliance can lead not only to arbitration but to reputational harm and can expose those working on a project – both corporations and individuals – to criminal investigation and prosecution. Less dramatically, but still extremely important for the economics of the project, local law issues will impact on the ability to:

- clear the site of prior occupants;
- take security over assets; and
- terminate contracts.

There are four particular problem areas where difficulties often arise – all of which have featured large in arbitrations in the region:

- Local labour regulations – the significant bearing local labour regulations have on personnel costs once any contract is awarded must be taken into account when formulating any bid. Failure to do so could have a dramatic impact on project profitability.
- Foreign investment restrictions – Malaysia, and many other countries in the region, have regulations restricting foreign direct investment in certain types of infrastructure project and these must be considered when structuring project participation.
Foreign currency restrictions – countries such as Nepal heavily restrict the free use and remittance of foreign currency, which can have a significant bearing on the funding and payment arrangements for construction.

- Language of the contract – for projects being developed in Indonesia, parties must be aware of local laws and regulations that require contracts to be bilingual (including both a Bahasa Indonesia and foreign-language version) to ensure the validity of the contract.

As a general principle, these types of mandatory law that apply in the jurisdiction of the project cannot be avoided. Before contracting, it is, therefore, necessary to properly understand these laws and their impact on the execution and profitability of any project.

**Choice Of Law Governing Contracts**

In many jurisdictions in the region, it is possible for parties to some of the contracts that make up a project to agree to use the laws of a neutral country to govern their contractual relationship, and thereby to contract out of some of the default local requirements. This practice is commonly followed for the main construction contract or engineering, procurement and construction (EPC) contract, and for financing documents; particularly where the parties to the contracts are themselves joint-venture entities, with members or sponsors from different states standing behind them.

English law is the most commonly adopted option for these types of complex construction contract across the Asia-Pacific region. It is typically seen to be a safe choice as it imposes few restrictions on parties’ freedom of contract and has easily accessible precedents to provide certainty. Even in these cases, local law will remain important. For example, obligations that are to be performed in Nepal, must be performed in accordance with Nepalese law, and local regulations will need to be followed and local permits obtained. Provisions addressing the allocation of responsibility for obtaining licences, or relief for change in law, are likely to be engaged by Nepalese regulations, not by English ones.

In many cases, it will not be possible to agree a neutral governing law, and the law of the country in which the project is being developed will be adopted. This could be because local laws do not permit a foreign governing law to apply, as is the case for some sector-specific contracts in Indonesia. Even where foreign laws are allowed, where a host country’s government is one of the parties to the contracts, local law will be used and, in most cases, even state-owned enterprises (SOEs) will see this as a non-negotiable issue. While the issues arising from local law are almost all perfectly manageable if identified at the stage of project procurement, a common cause of dispute, and ultimately of arbitration, is the failure to appreciate the ramifications of local law sufficiently early, meaning that the identification of local law issues – which should not be a surprise for anyone – fundamentally upends aspects of the (supposedly) agreed risk allocation.

This issue is commonly seen when construction projects are contracted using international standard forms, such as the International Federation of Consulting Engineers (FIDIC) contracts, rather than bespoke forms. In these instances, parties may assume that standard FIDIC clauses will be interpreted and applied in a way consistent with their experiences in other jurisdictions regardless of the governing law. This is a dangerous assumption, often proven to be false.
To take one example, most construction contracts provide that liquidated damages will be payable where the contractor delays in achieving completion. The purpose of this is to have a fixed pre-determined sum to compensate the owner for delay rather than the owner having to undertake a complex task of proving its actual loss. There is often an expectation by project owners that the parties’ bargain will be upheld and the right to payment of liquidated damages enforced. This is true in many systems of law (including English and Singaporean law). However, in contrast, some systems of law (often civil law systems such as Thailand) adopt a different approach and effectively treat the amount of liquidated damages agreed by the parties as a cap on liability, and provide a judge or arbitrator with discretion to decrease the amount payable by the contractor in certain circumstances. This can come as an unpleasant surprise when a project owner tries to enforce what it had previously understood to be a clear right to a fixed payment. Care should, therefore, be taken to ensure that these types of provision are enforceable under the parties’ choice of law for their contract, and that the parties understand the effect of the clauses that they are signing up to.

In another example, parties often forget the extent to which principles of good faith and fairness – which are often imposed in civil law jurisdictions – can have a significant bearing on the manner in which contractual obligations are to be performed. In China, for example, the fairness doctrine provides the basis for a change in circumstance defence that stretches far wider than force majeure and provides a court or tribunal with a broad ability to modify or terminate a contract.

Such local law issues must be fully understood at the time of contracting to help avoid unexpected outcomes which can lead to disputes.

**Mitigating Local Law Risks**

Disputes are common on major projects, and mismatching expectations and understanding of the applicable laws are a constant source of difficulty. Foreign project investors materially reduce the risk of finding themselves in dispute – and of their project failing – if they take the four following steps:

- **Undertake due diligence** – risks can be mitigated by undertaking thorough due diligence in advance of any project to become informed of the nuances of local law as soon as possible. It is better to be forewarned of any potential uncertainties and uncommon regulations so that these can be managed during the course of a project. Parties generally think of local law issues where it is obvious that they will arise and will be novel, such as land transfer, leasehold rights and mortgages. However, they are less alert to risks regarding familiar documents – such as the FIDIC terms – which they often assume will have exactly the same effect wherever they are used.

- **Agree to a neutral and familiar governing law** – where possible, this may assist in providing increased certainty and enforceability for complex construction contracts, even where contracts are based on international standard forms.

- **Agree to institutional arbitration with a neutral seat** – for large international projects, local court jurisdiction or ad hoc arbitration with a host country seat should be avoided. Instead, investors should agree to institutional arbitration under the rules of a well-established institution, such as the Singapore International Arbitration Centre or the International Chamber of Commerce (ICC). A neutral seat with developed arbitration law, such as Singapore or New South Wales, should be chosen. This will
ensure that the parties have access to an independent and experienced tribunal, with minimal opportunity for local court interference.

• Structure to avoid issues – structuring questions often focus on taxation; which is of course important, but there is more to consider. Structuring the corporate vehicles correctly may allow (or prevent) different procurement options and different governing laws. Further, structuring can allow a foreign party to take advantage of investment-treaty protection. Investors should always consider whether investment-treaty protection is available to them automatically and, if not, whether the investment should be structured in such a way so as to gain this protection. If so, the structuring should be done at the outset and before contracts are signed, as attempts to seek investment-treaty protection at a later date (eg, when a potential claim becomes available) will often be futile.

CONTRACTING WITH GOVERNMENTS AND STATE-OWNED ENTERPRISES

Large infrastructure projects in the Asia-Pacific region often have a public interest element and can involve a government or SOE. This gives rise to a number of important issues that parties should take into account when planning and executing projects.

Who Are You Contracting With?

It is necessary to understand whether a state is a contracting party. This may seem obvious, but in the Asia-Pacific region it is not always straightforward. The legal status of bodies and organisations can be opaque in certain jurisdictions. This is important for issues of state immunity against suit (where an arbitration clause is often a very helpful) and for immunity against enforcement. It is also increasingly relevant if the foreign investor intends to rely on protection under an investment treaty: any wrongful conduct of the counterparty being relied on must be capable of attribution to the state.

It is generally accepted that attribution can be established if:

• the unlawful conduct was committed by a state organ;\(^4\)
• the entity exercised governmental authority in its role vis-à-vis the investor;\(^5\)
• the implicated person or entity was acting under the instructions or control of the state when it committed the impugned acts;\(^6\) and
• the state acknowledged or adopted the impugned act as its own.\(^7\)

From the outset, investors should consider these criteria when contracting with a state-related counterparty. In particular, the following questions should be asked:

• To what extent can the entity make autonomous decisions without oversight or state control?
• Has the entity been established as a private company or does it have some other legal status such as a governmental body?
• Have laws been passed specifically for the purpose of establishing this entity?
• If the entity is a private company, who are its shareholders and how is control exercised?
• Who within the entity has decision making power?
• Why was the entity formed and what is its purpose?

As a general rule, the greater the extent of state ownership and control, the greater the likelihood that an investor may be contracting (even indirectly) with a host government.

**Sovereign Immunity**

Attribution may have a bearing on the enforceability of the contract or any arbitral award arising out of the contract, due to the contracting party’s ability to rely on sovereign immunity. States, their agencies and potentially SOEs, may claim to be immune from being sued or having any judgment enforced against their assets.

If a state is entering into a commercial contract (e.g., a construction contract) the foreign investors should be seeking an express waiver of any sovereign immunity protection. Getting a waiver is almost never a bad idea; however, its effectiveness is another area where local law must be considered. In simple terms, it is advisable to discover how far immunity can be waived, and whether any internal governmental processes are required to make that waiver effective.

While issues of immunity are not specific to the region, they are a particular concern given the frequent difficulty in ascertaining whether an entity is in the public or private sector. A detailed consideration of this point is critical for all projects in the region involving a state party, as a failure to agree an enforceable waiver could have disastrous consequences for the private party.

Even within the common law jurisdictions in the region, approaches to immunity differ. Singapore takes a very restricted view of when a state has immunity, while Hong Kong applies a much broader, essentially absolute form of immunity against suit. However, despite these variations, in most cases an agreement to arbitrate is likely to be the most robust choice from the perspective of compelling the participation of a recalcitrant state or SOE, and without other compelling criteria arbitration (and waivers of immunity against suit and execution) should be the default choice for dispute resolution in such cases.

**Change In Government**

In large-scale infrastructure projects with a public-interest element, problems can also arise when there are changes in government, government policy and law. Private parties need to be assured of stability given that many complex projects can take many years to complete and may be operated under long-term concessions.

While not all changes of government and law are problematic, many can have a significant adverse economic impact. This is particularly the case where new governments decide to cancel projects, introduce new laws and regulations or impose new taxes, which make executing a project more expensive and time-consuming. Sectors such as energy and water are particularly susceptible, as the emergence of new and more efficient or greener technology can incentivise a government off-taker to procure supply elsewhere, effectively reducing demand during the economic life of an asset.

To mitigate these risks, foreign parties should consider including stabilisation provisions in their contracts. While these provisions come in many different forms, as a general principle their objective is to provide stability and entitle the foreign party to relief in circumstances where there are changes to laws and regulations (and often the interpretation and application of laws and regulations) that have an adverse economic impact on the foreign party.
Stabilisation clauses are complex, not least because they are drafted to offer protection against unanticipated future circumstances; but imprecise or inadequate drafting in such clauses has again been a factor in a number of arbitrations in the region. Including a stabilisation clause is only half the battle – getting it right is the other half.

Inability To Settle Claims

It is commonplace that claims will arise in construction projects, whether simple variation claims, or complex time or defect claims. Managing these is a fundamental aspect of any project. Not all claims become disputes; in fact, most are settled without recourse to formal dispute resolution.

Most construction contracts have a mechanism for claims to be submitted on an ongoing basis. Such claims are then reviewed – sometimes by the employer or sometimes by a third party such as the project’s engineer – and a valuation is certified and paid. The involvement of states can complicate this where individuals are not properly empowered (or believe that they are not empowered) to make a valuation or to agree a settlement or commercial resolution of any claim that could later be argued to have not been in the state’s interests. There is a fear that settling a claim with some concessions could have repercussions for the individual involved. Consequently, there can be a preference for governments and SOEs to reject all claims – or at least all material claims – and instead have them decided through a formal adjudication process. This can be extremely frustrating, particularly where the value in dispute is not proportionate to the time and costs involved in formally resolving the claim.

Foreign investors should be aware of this issue and ensure that the contract provides for a dispute-resolution mechanism that will enable disputes to be settled in a time and cost-effective manner. For example, by choosing a tiered clause with an expert process or dispute adjudication board prior to arbitration, and with any arbitration taking place using a recognised international arbitration institution such as the ICC. At least then, if formal dispute-resolution proceedings are necessary, they can be concluded expeditiously and allow parties to use mechanisms such as expedited procedures.

INCREASED ENFORCEMENT OF ON-DEMAND PERFORMANCE BONDS

Taking security for non-performance is standard practice for project owners engaging contractors and for contractors engaging subcontractors. Most commonly, on-demand performance bonds or bank guarantees are used, which are intended to provide a rapid remedy that is sometimes described (if not entirely accurately) as being as good as cash. This type of security should therefore be paid out simply on the demand being made, without proof of default or breach of contract.

In recent years, project owners and lead contractors have increasingly looked to realise their security. They will call the bond or guarantee, obtain cash up front and argue about the consequences later. Conversely, we have seen that contractors are increasingly prepared to try to restrain banks from paying, via court or arbitration proceedings. In many cases, this results in multiple proceedings: local court proceedings against the bank that issued the security, and an arbitration between the project participants. This is an increasingly common aspect of construction disputes in the Asia-Pacific region.

There are, however, certain steps that can be taken to help minimise this risk and ensure that prompt recourse to security can be obtained and long drawn-out battles before courts
and arbitral tribunals about the validity of a payment demand can be avoided or at least
minimised.

**Step 1: Ensure The Bond Is Truly On-demand**

The project owner (or lead contractor) should ensure that the security contains no (or as few as possible) conditions that must be satisfied for a call or demand to be made. Typically, there is a tension with the contractor’s (or subcontractor’s) objectives, as they would prefer that it is as difficult as possible for a valid call to be made.

In determining whether a bond is on-demand or conditional it is not enough to rely on the name given to the document. In the New Zealand case of Richina Pacific Limited v Samson Corporation Limited [8], which went all the way to the Supreme Court, the Court was faced with a bond whose preamble stated that it ‘is in the form of an on-demand bond’, but as the Court noted, ‘there seems to be little else to support that label’. It will be the content, not the title, of the instrument that determines its nature.

A common compromise in the region between the competing interests is for bonds to incorporate by reference the Uniform Rules for Demand Guarantees, which were first adopted by the ICC in 1991. These rules contain limited safeguards which are designed to give some protection against unfair demands including:

- a requirement that after a demand is made the project owner must transmit a copy of the complying demand and any related documents to the contractor; and
- a requirement that the demand must be made in writing and accompanied by a supporting statement indicating which obligations the contractor is in breach of.

The question of whether the format of a security allows a demand to be made is one of the most common reasons for the parties needing to appoint an emergency arbitrator and, where an injunction is sought against a bank, one of the most common reasons for the parties to find themselves in the local courts despite the existence of an arbitration agreement. Making the scope of the bond crystal clear is fundamental.

**Step 2: Prescribe Requirements For The Security**

From the owner’s (or lead contractor’s perspective), security should be obtained from a reputable bank from a country with an established banking system. Often the underlying project contracts will prescribe some criteria for the issuing bank. For project owners, the best option is to stipulate the specific institution. If this is not possible, at the very least, the project owner should set requirements as regards the location and credit ranking of the issuing bank.

Another important consideration is the extent to which the courts in the location of the bank may act to restrain (via an injunction) a call on the security. In some jurisdictions, experience suggests that it is relatively straightforward for parties to obtain (at least ex parte) injunctive relief. In others, it is much harder.

The choice of law governing the security is also critical as in some jurisdictions, such as Singapore, this may determine the legal standard that must be met by a party seeking to obtain injunctive relief.

Each of these considerations will, therefore, have a material effect on the utility of the security and care should be taken to negotiate these requirements carefully.
BELT AND ROAD INITIATIVE

In addition to the normal market pressures, the projects market in the region is heavily influenced by the development of Belt and Road Initiative (BRI) projects. ‘Belt’ refers to economic and overland transport links connecting China to Central Asia and Europe via six economic corridors, while ‘Road’ indicates a network of maritime routes connecting Asia, the Indian Ocean, the Middle East, Africa and Europe. Much of the Asia-Pacific region is, therefore, central to the BRI.

From 2013, as part of the BRI, China has played a very active role in many regional projects. It is estimated that BRI projects will add over US$1 trillion of outward funding for foreign infrastructure between 2017 and 2027. Most of this funding will come from state-directed development and commercial banks. This means that foreign investors and host states will often find themselves contracting with Chinese SOEs. Chinese involvement is not limited to funding. Increasingly, Chinese contractors are also being engaged to execute the projects, and many SOEs are also taking equity in projects. However, to add to the complexity, the BRI is not simply a Chinese investment. China is supporting a multilateral approach to investment meaning that it has been and will continue to invest in projects alongside multilateral development banks and with states in private public partnerships.

Further, we are seeing an increasing number of non-Chinese investors, as well as non-Chinese contractors and developers. While maintaining its Chinese origin, BRI projects are increasingly international in their feel.

These investments may bring with them different cultural, legal and commercial expectations for project participants. For example, some parties may value face-to-face communication and the development of relationships based on trust and perceived fairness, which can sit at odds with the often strict requirements of construction contracts in relation to the issuing of notices and management of claims. A heavy reliance on foreign manpower for project execution can also create issues where all project participants are having to communicate in a foreign language. For example, we have seen a number of disputes that have been exacerbated by communication problems caused by the fact that, while no one on the project was a native English speaker, English was the only common language in which the teams from the employer, the contractor, the engineer and the subcontractors all had a degree of proficiency, and many communications effectively went through multiple translations before being communicated to site.

The ICC has been actively positioning itself as the go-to institution for BRI disputes. It certainly has a global presence and global brand, which means project participants from different jurisdictions are likely to feel comfortable using it. However, while many Chinese SOEs are increasingly comfortable agreeing to arbitration in neutral seats such as Singapore, and using international institutions to administer cases, some involved in regional infrastructure projects may still propose domestic arbitration under the rules of a Chinese institution (e.g., the Shanghai International Arbitration Centre or the China International Economic and Trade Arbitration Commission). Hong Kong is marketing itself as a hub for these disputes by offering the attraction of being part of China and yet having a separate legal system – including a very well-regarded arbitration framework – allowing a best-of-both-worlds pitch to be made.

Further, arbitration is not the only option. With a view particularly to BRI disputes, China’s Supreme People’s Court has established new international commercial courts to handle a
broad range of international disputes. Chinese parties may wish to have disputes resolved within the new Chinese International Commercial Courts.

It is too early to say how the BRI will impact on dispute resolution in the region. However, it can already be said that the BRI projects are vast and there is scope for them to change parties expectations of how to resolve construction disputes, and to establish a new normal that could impact not only BRI projects but other international deals too.

CONCLUDING REMARKS

All international infrastructure projects involve risk. Projects in Asia-Pacific are no exception. Companies engaged in owning and building infrastructure in the region will have to successfully navigate these risks to maximise their return on investment. To achieve this, a nuanced understanding of the regional legal, regulatory, political and cultural environment is critical.

Nevertheless, given the scale of infrastructure investment and development around the region, it is expected that construction and project-related disputes will continue to increase. New forums are being established and new pressures are driving behaviours. Global trade and geo-politics have always been influential, but they less predictable now than ever before. This is a time of change in the industry and all participants need to be open-minded and flexible to deal with what lies ahead.

Endnotes