Global construction update

The volatility issue

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ReedSmith

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Contents

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Global construction update

Welcome

"Fragile" is a word being used to describe the global economy in 2023. The OECD has projected that global growth will remain at "below trend" rates in 2023 and 2024, at 2.6% and 2.9% and the World Bank has reported that nearly all the economic forces powering prosperity over the last thirty years are fading. In more positive news, some observers suggest that in Q2 2023 the global economy is modestly rebounding.

In the construction industry, we do not need statistics or reports to know the outlook. Reed Smith's clients around the globe are sharing their concerns. In a sign of the times, our construction arbitration and disputes practices are busy. Yet amidst the global pressures, our clients also see tremendous opportunities. In Europe, renewables projects (solar, onshore and offshore wind, and hydropower) are tipped to account for almost 84% of total power generation by 2050. In Saudi Arabia, the real estate construction market has been predicted to grow by 9% to a total of USD 324 billion by the end of 2023. And North America continues to dominate the global industrial construction project pipeline with spending on such projects to reach USD 194.8 billion in 2023, if all go ahead as planned.

It is against this mixed economic backdrop that this edition of Reed Smith's global construction update explores the theme of "boom or bust" and volatility. Across all our feature articles is a persistent message – the successful delivery of projects increasingly depends on rethinking risk allocation. Contractors and developers alike are advised to challenge the accepted wisdom of 'standard market practice' because the economic and political climate is anything but standard.

In this edition:

- Richard Ceeney and Laura Riddeck (London) offer practical legal tips to protect against risk and volatility, suggesting that complacency in due diligence and risk allocation on projects has led to a perfect storm for claims.
- Michelle Nelson and Chris Edwards (Dubai) challenge the standard market practice of 'on demand bonds' in the UAE, asking whether developers should rethink security on construction projects.
- Matthew Harley (Dubai) provides a civil law perspective on 'economic hardship' principles under the laws of GCC countries, which may provide legal respite in cases of unpredictable, exceptional circumstances that threaten exorbitant losses on a project.
- James Willn and Finlay Donaldson (Dubai) consider how contracts can mitigate price fluctuations and labor shortages, while highlighting the increased importance of robust project investment appraisals to ensure the feasibility of projects.
- In a spotlight on our US practice, James Doerfler and Gesue Staltari (Pittsburgh) offer five strategies for driving greater certainty in construction contracts, from a US market perspective, including innovations around expanded force majeure provisions, increased use of cost-plus and guaranteed maximum price contracts with contingency provisions, judicious use of liquidated damages clauses, and others.
- In a Q&A session, Vanessa Thieffry (Paris) tells James Doerfler (Pittsburgh) about the challenges facing her clients in the current economic climate, including parties' attempted use of force majeure claims to rebase or recalibrate a project.
- To conclude, Nicolas Walker, Adrien Hall and Michaela Hanzelova (Paris) highlight new sustainability regulations in France that are expected to drive growth in the construction sector.

We also celebrate the successes of our global construction team over the first half of 2023. Select examples include:

- For the fifth consecutive year, leading publication Global Arbitration Review named Reed Smith's international arbitration practice in its list of the world's top 30 international arbitration law firms – the elite GAR 30. This year, our practice has risen 11 places to # 13 – a phenomenal ascension – and our global construction arbitration practice is a significant contributor to this ranking and recognition.

- Reed Smith was shortlisted for 'Diversity Initiative of the Year' at the Middle East Legal Awards for the UAE offices' webinar series 'Maximising Female Talent in Construction' delivered in collaboration with global consultancy HKA.
- Turning to directories, Sachin Kerur and Michelle Nelson remain in the Legal 500 EMEA UAE 2023 Hall of Fame for construction. Also maintaining the top spot is our construction practice, holding fast at band 1. Separately, our international arbitration and dispute resolution practice write-ups and rankings in the Legal 500 EMEA 2023 France and UAE respectively credit construction and infrastructure projects as part of these practice group success stories. Looking to Chambers Global 2023, clients note that the construction team has "the exceptional ability to evaluate complex legal matters and provide out-of-the-box solutions."
- Peter Rosher (Paris), Michelle Nelson and Sachin Kerur (Dubai) were ranked in the Who's Who Legal "Global Leader" category for Construction 2023.

Our construction lawyers have also been busy presenting and making connections:

- Peter Rosher (Paris) co-chaired GAR Live Construction Disputes for the fifth consecutive year during Paris Arbitration Week. Alison Eslick (Dubai) was a panelist at the event on GAR's 'The Terminator 1' panel, speaking on termination of construction contracts.
- Sachin Kerur (Dubai) attended the 'Leaders in Construction Qatar: Analysing The Legacy of Qatar Construction Post-FIFA' in Doha.
- Jarett Dillard (Houston) attended the 36th Annual Construction Law Conference – The Construction Law Foundation of Texas.
- Richard Ceeney and Laura Riddeck (London) attended the Infrastructure Investment Event – Global Summit Berlin 2023.
- James Willn and Chris Edwards (Dubai) presented alongside guest speakers Gurminder Singh Sagoo (Egis) and Christopher Seymour (Mott MacDonald) at a Reed Smith hosted Construction Breakfast Briefing, moderated by Sachin Kerur, on the topic 'Outlook for the Middle East construction industry in 2023'.
- Erwan Robert (Paris) moderated a panel session on "Inflation in the international construction sector" hosted by the association Young Professionals of Construction in Paris (YPCP).
- Antonia Birt (Dubai) presented on 'Unconscious Bias in the Legal Industry' at an event hosted by CCi, A Rimkus Company to celebrate International Women's Day and Women in Construction Week.
- Liam Hart (London), Chris Edwards, James Willn and Finlay Donaldson (Dubai) all presented podcasts on nuclear power plant contracts and the complexities of nuclear disputes for Reed Smith's 'Energy Explored' podcast series.
- Sachin Kerur (Dubai) was a panelist at the prestigious Middle East Consultant C-Suite roundtable event, featuring CEOs and senior executives at the forefront of decision-making in the UAE and their response to the evolving economic factors of 2023.
- Michelle Nelson (Dubai) moderated the first webinar in our 'Maximising female talent in construction' series, on the topic 'Attracting and retaining female talent in the construction industry,' with over 300 attendees registering for the event.

We look forward to working with all our clients and construction industry colleagues throughout 2023.

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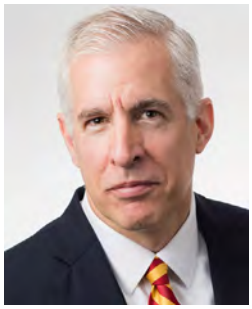

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Global volatility drives uncertainty and risk

Following a sustained period of global economic stability, a number of market factors are now combining to create economic volatility. While the impact of COVID-19 is diminishing, other factors such as the war in Ukraine are driving up inflation generally, and particularly the cost of fuel and construction materials. This uncertain set of conditions is creating a number of challenges for all players in the construction industry. This article briefly addresses some strategies that developers are increasingly utilizing to address these current market.

Pre-construction phase

In the pre-construction phase, supply chain unpredictability is making it particularly difficult for contractors to price projects. For many years, the trend has been toward fixed pricing, with contractors (and subcontractors and suppliers down the supply chain) taking the risk of fluctuations in labor and materials costs.

Price indexing and other price fluctuation clauses

Every risk allocation, however, carries a cost, and the risk premium of covering new inflationary factors in these uncertain times may be prohibitive for contractors, particularly on substantial projects with long construction periods. Increasingly, developers are considering introducing price fluctuation mechanisms that allow contractors to adjust their prices, with reference to impartial indices (whether the official inflation index of the relevant country or an index that tracks changes in prices of steel or other materials or of local labor). These mechanisms provide certainty to contractors, but not to developers or financiers.

So, how can a developer assess the profitability or even viability of a construction project when the capital expenditure cost is uncertain not only during the planning and design stage but also during construction?

And, in an environment where projects are increasingly difficult to finance, will financiers be willing to provide development or project finance on a project that has limited capital expenditure (CapEx) certainty?

Hybrid and cost-sharing clauses

A hybrid system, either with a sharing of cost overruns or a guaranteed maximum price ceiling, may provide a workable compromise solution. Sophisticated developers may also be more open to exploring multi-contracting solutions to give greater flexibility when navigating a challenging market.

Construction phase

For projects already under contract, volatility is also causing significant complications. Most construction contracts will not allow for price adjustments, meaning the contractor needs to absorb any cost increases. Even where a party seeks to protect its supply chain by allowing for price adjustments in its contract, it may still be that commitments that its contractors, subcontractors and suppliers have given on their other fixed-price projects will lead to supply chain insolvencies, which can be highly problematic to a construction project, since they inevitably cause delays and duplication of expenditure, as well as continuity and quality concerns.

Insolvency of subcontractors and suppliers and other downstream risks

Ultimately a strong contract that passes substantial risk to the contractor is of little use to the developer if the contractor is forced into insolvency. During the last decade, a degree of complacency has developed over financial due diligence toward counterparties, over bonding for advance payments and insolvency, and over the passing of title (and vesting certificates establishing title before payment). Unsurprisingly, all of these factors are quickly becoming important.

Common claim situations

Inevitably, such uncertainties lead to claims. The construction contract may provide an entitlement to additional time and/or additional cost, depending upon the cause of the external factor. Most construction contracts, for example, would consider both COVID-19 and the war in Ukraine to be force majeure events, giving an entitlement at least to extensions of time. Any claim to give effect to this entitlement needs to be carefully managed, however, and many construction contracts contain pitfalls for both parties if claims procedures in the contracts are not followed. Similarly, claims received need careful handling, to avoid any acceptance of liability for excessive or invalid claims.

Particular care is required when a contract allows no entitlement for the event that is causing delay and cost. In these circumstances, rather than simply absorbing this delay and cost, many contractors or subcontractors will seek to mitigate their losses by attributing their delay and cost exposure to other events which do legitimately give rise to an express entitlement.

The importance of good project records

During periods of extreme volatility, formal disputes may become inevitable. For this purpose, detailed record-keeping is key, as it may be the only way to establish or disprove an alleged entitlement.

Conclusion

As we move away from COVID-19, with many regions keen to generate revenue back into their economies, and with an increasing focus on the energy transition following the invasion of Ukraine, construction deals will continue to be made. The market volatility that we are seeing will make those deals more complex. And contract terms that might have been considered acceptable even 12 months ago may now carry a dangerous level of risk. Developers, contractors and funders alike need to be wary.

Takeaways

- Exposure to fluctuating prices creates new risks for developers.
- Developers must address potential contractor insolvency.
- Effective and proactive claims management is crucial.
- Keep clear and contemporaneous records.

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Rethinking security on projects in the UAE

With difficult economic headwinds, rising interest rates and general pressure on liquidity, contractors are increasingly struggling to obtain customary financial and performance security instruments for projects, such as letters of credit, bonds or guarantees. Where such security instruments are available, they are often expensive, and this circumstance has a knock-on effect on bid pricing and, in some cases, may prevent contractors from bidding on projects at all. This difficulty in obtaining customary project security has a negative impact on not only contractors but also owners, who are finding that their resource contracting pool is dwindling and their project costs are rising.

In this article, we consider the practice in the UAE in respect of project security and, particularly, how this sits alongside other jurisdictions such as the UK and U.S. We also discuss whether there might be alternative practices and whether taking a different approach might bring about positive change to the market, both for owners and contractors.

Security practices on projects in the UAE

In the UAE, a combination of unconditional/on-demand performance, advance payment, retention and defect bonds is customary. There is usually very little (if any) room for a contractor to negotiate with an owner in respect of security, in terms of either providing the instrument or the conditions in which it can be called upon by the owner.

Likewise, the provision and maintenance of such security tends to be a condition precedent to payment under the contract. Furthermore, if the contractor fails to maintain or increase security in line with increases in the contract price, such a failure typically entitles the owner to encash the bonds and is often a contractual termination event. Contracts rarely provide for any form of notice or other requirements preceding a call on the bonds.

The content of the bonds themselves varies depending on the issuer and the project but will typically include an unequivocal obligation on the issuer to pay the owner upon receipt of a written demand notice and expressly exclude any right to challenge a call. By way of example, standard form bonds typically include wording similar to the below:

> *"Our obligations constitute direct primary, irrevocable and unconditional obligations and shall not require any previous notice to, or claim against, the Contractor."*

> *"Any demand made by you in accordance with this bond shall be conclusive evidence that the amount in demand is properly due and payable."*

> *"We agree that we shall have no right and not be under any duty or responsibility to enquire into the reason of any demand and/or the respective rights, obligations and/or liabilities of yourself and/or the Contractor under the Contract."*

In such circumstances, the owner is free to call on a bond at its discretion. This discretionary right makes the unconditional/on-demand bond a very safe and preferred form of security for the owner. However, bond calls in the region have become alarmingly common and, in some cases, are not always justified. The frequency and high risk of calls being made has significantly increased the costs of such bonds to contractors, and in some cases, banks are now refusing to provide them or are imposing extremely onerous terms on the contractor, such as including a requirement to provide a counter-guarantee from their "home" bank, in circumstances where the contractor is not based in the UAE.

This increasingly challenging environment for contractors is exacerbated by the fact that UAE law offers little protection to contractors in respect of unconditional bonds. In particular, the Commercial Code explicitly provides that:

a. a bank may not refuse payment to the beneficiary of an unconditional guarantee on grounds of the bank's relationship with the person making the order or the relationship of the latter with the beneficiary;[1] and

b. a court may only intervene to place an attachment on an unconditional bond in "*exceptional cases*" where the person seeking the order relies on "*serious and sure grounds*."[2]

While we have seen some recent examples of the courts granting attachments, preventing a bond call from being paid out, historically, the courts have been reluctant to intervene, which is perhaps unsurprising given the high legal threshold for such intervention.

Accordingly, contractors are struggling to meet bonding requirements on projects in the UAE. Either the security is simply unavailable to them, or if it is available, their bids are inflated by the high financing costs of their banks. Ultimately, this situation is not in the interests of owners since they can no longer attract the right talent at the right price for their projects.

A comparison with other jurisdictions

While the unconditional bond has become the norm in the UAE, this is not the case elsewhere. For example, the position in the UK and U.S. in respect of guarantees and security is very different.

On-demand bonds are occasionally used in the UK, particularly on large infrastructure or energy projects with an international contractor or where the employer is the UK government (which can leverage its position as a major consumer). However, default bonds (also known as conditional bonds) are far more common.

Default bonds in the UK tend to adopt the standard Association of British Insurers (ABI) form of bond, which provides that a call can only be made when damages are crystallized under the contract. The key operative provision of the ABI form of bond states as follows:

"The Guarantor guarantees to the Employer that in the event of a breach of the Contract by the Contractor, the Guarantor shall subject to the provisions of this Guarantee Bond satisfy and discharge the damages sustained by the Employer as established and ascertained pursuant to and in accordance with the provisions of or by reference to the Contract and taking into account all sums due or to become due to the Contractor."[3]

This practice of using conditional bonds provides a layer of protection to contractors and banks, as a call can only be made in respect of damages that have been "established and ascertained" under the contract. Therefore, unlike the situation we often see in the UAE, bonds on projects in the UK typically cannot be called at the whim of the owner.

In the U.S., if bonding is required, it will usually take the form of either: (i) a surety performance bond, where a surety promises to take over a contractor's or subcontractor's work if the contractor or subcontractor defaults or becomes insolvent; or (ii) a payment bond, which guarantees that all subcontractors and material suppliers on a project engaged by the main contractor are paid for their work.

1 Article 417(1) of the Commercial Code
2 Article 417(2) of the Commercial Code
3 Association of British Insurers (ABI) form of construction bond

The U.S.-style surety performance and payment bonds are quite different from the bonds provided on projects in the UAE. They are not simply a lump sum that can be drawn upon on demand. They meet specific project-driven requirements, and can only be used/called in clearly defined circumstances outlined in the terms of the bonds.

The use of UK or U.S.-style default bonds, surety bonds and/or payment bonds could all be attractive alternatives to the unconditional bonds used in the UAE. The owner's interests would still be protected, but the risk and costs to the contractor could be greatly reduced.

Other options?

Various amendments to security provisions in contracts have been trialed and mooted in the region in an attempt to make them more equitable, such as introducing notice provisions or a stand-alone dispute process before a bond call. However, these possible amendments, while solving some problems, tend to come with their own sets of complications.

Notice provisions

A notice provision will usually require an owner to notify a contractor of its intention to call a bond unless a specified breach is rectified within a defined period. This advanced notice is often seen as a good compromise for a contractor. It ensures that a bond call is linked to a specific breach of the contract, and it allows the contractor some time to either rectify the breach or prepare for the consequences of the bond call.

However, there is an inherent risk to the owner that, upon receiving such a notice, the contractor may seek an attachment in the court to prevent a call on the bond being made or take other measures to prevent a successful call (other than rectifying the alleged breach). Further, unless the notice provisions are clearly drafted and carefully followed, the contractor may challenge a call for failure to comply with the notice provisions.

Stand-alone dispute resolution processes

A stand-alone dispute resolution mechanism is another method used to prevent unjustified calls on bonds. These are also known as adjudication bonds. Adjudication bonds are not widely used. While at a high level, the concept may be appealing, when one delves into the details, the value of adding such a process often becomes questionable.

In particular, the adjudicator is usually the guarantor (who would be unlikely to be fully impartial) and the process would likely be ad hoc, as adjudication is not a well-established forum in the construction industry in the Middle East. Given the lack of experience with adjudication bonds, banks may be reluctant to issue such a bond and there would be a significant risk of complications in implementing the process, and as a result, delays, more costs and, potentially, the call being rejected or the guarantee becoming invalid.

Accordingly, while amending the contract provisions in these ways may bring some comfort and additional protection to contractors, it is not without risk, particularly to the owner.

Could we do away with bonds altogether?

There may be other solutions outside of bank guarantees that could be attractive to contractors, and could lower prices, while also reducing the owner's exposure.

If a holistic view is taken of the types of obligations that traditionally require security on a construction project in the UAE, it is arguable that a bond may not be required at all. For example:

1. **Performance** – in some cases, a guarantee can be issued by a parent or affiliate company in lieu of a performance bond. These parental or corporate affiliate guarantees are usually easier to obtain than a bond and should have cost benefits, while also limiting the owner's exposure to performance default risks.

2. **Advance payment** – the advance can be paid into an escrow account with joint control and money only paid out in accordance with an advance payment plan provided by the contractor and signed off by the owner. In such circumstances, the requirement for security is reduced, or even eliminated, as the owner has greater control over release of the funds.
3. **Retention** – a guarantee is only required where the owner releases the retention to the contractor prior to it becoming due under the contract. If this mechanism is removed, i.e., there is no option for an early payment of the retention, then there will be no requirement for a guarantee. Alternatively, the parties could remove the requirement for retention from the contract entirely. Ultimately these sums are certified amounts that the contractor has earned through its progress on the project.

It may be a step too far for owners in the UAE to do away with bonds entirely, particularly in a market that is so accustomed to significant unconditional and on-demand bonds being provided by contractors. However, it is important to keep in mind the underlying purpose of such security and the overall goals. If an owner wants a larger pool of contractors, specific contractors or cheaper bids, then a balancing act is clearly required.

Conclusion

There is no one-size-fits-all approach that would work for all construction contracts across all jurisdictions. There are significant variables that need to be taken into account, including the identity of the parties to the contract, the type of contract, the nature and size of the project, market conditions and local laws, among others.

The unconditional on-demand bond may well be the right approach in certain circumstances. However, it is clear that there are increasing calls in the region for more options that will ultimately benefit not only the contractors, but the owner as well. Whether this is achieved by adopting project security approaches commonly used in the UK or U.S., amending the provisions of the contract to provide for notices or discrete ADR, or doing away with bonds altogether, it is clearly an important discussion to have to identify solutions which will work for the specific parties and the project, while satisfying the purpose of providing such security.

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Inflation, price increases and economic uncertainty: the impact on the construction industry in the Middle East

Since the Covid-19 pandemic began in 2020, much has been written about force majeure, impossibility and the civil law concept of excessive hardship. In 2023, with the pandemic behind us, these concepts are being invoked in different circumstances. We are increasingly seeing contractors invoking economic turmoil, particularly (1) high inflation; and (2) increasing prices of raw materials, to argue that contractual obligations should be modified, or even set aside entirely.

The legal systems of the Gulf Cooperation Council ("**GCC**") countries give primacy to parties' agreements, and seek to uphold parties' contracts. However, compared to common law systems, the laws of the GCC countries give judges and tribunals greater power to amend parties' contracts to limit unfairness or avoid excessive hardship when economic conditions change significantly. For example, under UAE law, where the performance of a party's contractual obligations is impossible (for example in a force majeure scenario), its counterparty's corresponding obligations are also deemed to be canceled and the contract is automatically terminated, unless the parties agree otherwise.

It is often difficult to prevail with such arguments before judges or tribunals. However, the GCC legal systems contain related concepts where the threshold for success is set lower. For example, under UAE law, a judge or tribunal can modify contractual obligations if, because of unpredictable and exceptional circumstances, performance in accordance with the terms of the contract would threaten a party with "*exorbitant loss*." Judges and tribunals have broad discretion to modify contractual obligations in such cases to reasonable limits, taking into account all of the circumstances. Importantly, parties cannot opt out of this doctrine, which is of mandatory application.

Some GCC legal systems also contain provisions specific to construction contracts, which provide more rights to parties to construction contracts than parties to other types of contracts. For example, in construction contracts governed by UAE law, a party may ask a court or tribunal to terminate a contract if "*an excuse*" arises, regardless of what caused the excuse, and regardless of whether the circumstances that prevent the party from performing its contractual obligations were foreseeable. Finally, if a contractor commences work but becomes incapable of completing it because of a cause outside its control, it is entitled to payment for the value of the work actually completed and the expenses incurred in performing that work, commensurate with the benefit the employer derives from the work.

We are currently assisting employer clients who are experiencing these arguments from contractors, with contractors asserting that high inflation and/or increases to the cost of raw materials should lead to an increase to their remuneration. Contractors and employers in the Middle East should therefore be aware of these legal concepts, and the possibility that their counterparties may argue that contractual obligations should be modified in the face of economic turmoil. Economic disruption is likely to continue in the short term. Such arguments will therefore likely arise with increasing frequency. They provide a possible alternative legal theory for relief, especially in situations where recourse to relief utilizing traditional impossibility or *force majeure* concepts is unlikely to be successful.

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Outlook for the Middle East construction industry in 2023

Introduction

On Thursday, March 16, 2023, Reed Smith's Dubai office held its latest construction breakfast briefing focusing on the outlook for the Middle East construction industry in 2023. A main aim of the breakfast briefings is to gather a broad range of construction industry professionals, including developers, contractors, subcontractors, experts and consultants, in one place to facilitate an open and frank discussion about the most pressing issues facing the industry.

Among the topics discussed during this briefing were the issues of fluctuating material costs, the impact of international sanctions and supply chain shortages. In this article, we outline a number of key issues and consider how these issues can be addressed and mitigated.

Price fluctuations

Understandably, the issue of fluctuating material costs was a key theme discussed by our panelists. The recent price increases are largely attributable to the inflationary impact of international sanctions imposed against Russia over the past year.

In order to counter the impact of such price increases, the panelists agreed that parties should consider drafting price escalation (or fluctuation) clauses into their construction contracts. A price fluctuation clause is a contractual mechanism that allows a contractor to pass on increased overheads to an employer. If the price of materials increases, a price fluctuation clause acts to increase the final contract price to allow a contractor to recover some of the increased overheads.

By way of example, the JCT Design and Build contract contains a fluctuation provision, allowing for an adjustment to a contract price following fluctuations in the market price for labor and material. The provision provides three different options for calculating the required adjustment to the contract sum. Further, the FIDIC Red Book 2017 contains a provision accounting for a change in costs, which, in periods of stable material costs, is often deleted or amended by contracting parties.

Given the significant cost implications of a price escalation clause, particularly on an employer, such clauses should be drafted very carefully and the contracting parties must be aware of the potential impact of such provisions.

In the Middle East, it has been historically rare to see price fluctuation clauses within construction contracts and the accepted position was that increased overheads were simply a risk borne by the contractor. However, the unprecedented price increases witnessed over the past 12 months requires a re-evaluation of this status quo.

From a practical perspective, contractors and subcontractors may wish to consider pre-purchasing and stockpiling materials at the outset of a project to protect against fluctuations and to provide greater cost certainty. Additionally, purchasing materials directly from a supplier can avoid costly mark-ups from intermediaries.

Labor shortages

A further issue addressed by our panelists was supply chain issues due to the shortage of available contractors and subcontractors in the region as well as the increased competition for skilled workers. This shortage is largely driven by strong demand in India, where local contractors usually deployed around the region are currently tied up on domestic projects, as well as the unprecedented demand for labor from Saudi Arabian giga-projects, including NEOM, Diriyah and the Red Sea Project.

As a result of such shortages, parties must ensure that they secure the necessary skilled labor as early as possible for new projects in order to avoid delays. Further, and where possible, parties should invest time and resources in upskilling their own employees through the development of a professional training scheme.

Investment appraisals

Given the ongoing issues around price fluctuations and labor and material shortages, our panelists agreed that a greater emphasis needs to be placed on conducting a proper investment or financial appraisal of a new project at the outset. Traditionally, developers in the Middle East have not tended to conduct meaningful market research or an investment appraisal for large projects and, particularly in fast-growing areas such as Dubai, there has been a tendency by some developers to adopt a "build it and they will come" approach to market research and appraisals.

However, given the challenging market environment at present and the increased competition in the region, it is recommended that for future projects in the region, developers conduct a detailed investment appraisal considering the potential profitability of a project.

For businesses operating in the construction industry, potential issues can be difficult to manage and require extensive resources. Reed Smith's global team of projects and construction lawyers are very experienced in handling issues arising out of construction projects and are ideally placed to assist.

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A U.S. perspective: strategies for certainty in construction contracts during uncertain economic times

The construction industry in the United States has faced serious economic headwinds in the past several years. An exceptionally tight trade labor market and dramatic increases in the price of construction materials have strained owners' budgets and shrunken (or eviscerated) contractors' margins. The global COVID-19 pandemic not only supercharged these issues, it also combined them with inefficiencies, supply-chain interruptions, and inflation. Although donning masks is hopefully a thing of the past, these legacy economic disruptions are forecast to continue, especially in the wake of the war in Ukraine and its own impacts on the global economy.

Commercial construction professionals have increasingly responded to these economic challenges and their associated risks with a series of strategies that modify or re-cast some common contractual arrangements, including: (1) the inclusion or expansion of *force majeure* provisions; (2) the inclusion of materials price escalation provisions, (3) the adoption of early work release procurement arrangements; (4) the increasing use of cost-plus project delivery systems over fixed-price schemes; and (5) a reduction in the severity of liquidated damages provisions.

This Article addresses the trends and strategies for each of these clauses in the post-pandemic economic environment.

Strategy 1: expanded *force majeure* provisions

Although it took the world by storm, courts and owners alike found the pandemic to be something less than "*force majeure*," as many pre-pandemic contracts and cases defined that term. Surprisingly, many standard commercial contract templates neither defined nor specifically accounted for *force majeure*. For example, the American Institute of Architects' (AIA) A201-2017 General Conditions of the Contract template, the industry's most commonly-used set of commercial terms and conditions, lacked any *force majeure* provision. In the pandemic's aftermath, owners and contractors have insisted and (should insist) on the inclusion of a *force majeure* provision in their contracts. Contracting parties should draft that provision to account for pandemics and epidemics, other global health-crises, ***and*** their potential disruptions, including (among others) government-mandated shutdowns, materials and labor unavailability, supply chain disruptions, and drastic price increases. Because courts ordinarily interpret contractual provisions according to their plain meaning, adopting a more expansive definition of *force majeure* will lower the threshold of qualifying events and increase the possibility that contracting parties may take advantage of the benefits and protections in those terms.

And while traditional *force majeure* clauses usually assumed a *force majeure* event would terminate or suspend the contract indefinitely, post-pandemic *force majeure* provisions should be drafted on the assumption that the project will continue. In this regard, these provisions should clearly define the *force majeure* event's contractual effect on the project's schedule and contract price, including by addressing any associated material price escalations or extensions of time for the purposes of calculating liquidated damages, as discussed further below.

Strategy 2: material price escalation provisions

In the past three years, prices for steel doubled, they fluctuated wildly for lumber, and they have jumped 20 to 40 percent for concrete products. While significant, these price impacts are, ordinarily, not sufficient to constitute *force majeure*. They are also unlikely to render performance commercially impractical or impossible, as courts have historically understood those concepts. To mitigate the impacts of these price changes (especially since the pandemic), many sophisticated contractors are increasingly including materials price escalation provisions in their contracts. These provisions allocate the risks and costs associated with price changes between the contracting parties. There are number of potentially effective strategies for accomplishing this goal, and while parties often draft bespoke price escalation provisions, major industry groups have begun to address the issue through their contract templates. For example, the ConsensusDocs 200.1 Time and Price Impacted Materials Amendment employs a variety of risk mitigation tools, including: (a) time limits on quotes for materials; (b) project phasing; (c) allowances for alternate materials; (c) early materials procurement and storage; (d) materials prefabrication; and (e) higher contingency amounts. Parties may also wish to consider objective price-increase thresholds, beyond which the contract may entitle the contractor to an equitable adjustment to the contract price, subject to a negotiated cap. Whatever the particular mitigation strategy, effective price escalation provisions should equitably allocate the risks and costs associated with price increases among the parties and clearly establish objective, appropriate boundaries for their use.

Strategy 3: early work and procurement releases

Commercial construction projects often require sophisticated equipment or imported materials with long lead times. In the face of supply-chain disruptions and price escalation, strict adherence to the traditional design-bid-build project delivery system may render these materials and equipment either too late or too costly to fit within a project's schedule and budget. This system may also prolong the project's schedule, particularly if the project requires highly specialized work to occur earlier in the project schedule.

Even before the COVID-19 pandemic, sophisticated owners and contractors increasingly adopted the Construction Manager At-Risk (CMAR) project delivery system to maximize savings and reduce the project's duration. This project delivery system breaks the project into two phases – (1) a pre-construction and procurement phase and (2) a construction phase – and gives the owner's construction manager (CM) a central role in each. In the pre-construction phase, the CM works with the owner and design professional to refine the project design criteria, engage in value engineering, and begin the procurement and trade contractor bidding processes. In the construction phase, the CM acts as the project's general contractor or is otherwise responsible for the project's management.

This delivery system permits the CM to identify and procure long-lead materials and equipment before the design and procurement process is complete. In the current era of price instability and supply chain disruptions, well-advised construction professionals have increasingly utilized this pre-construction phase to lock-in prices for materials and ensure favorable delivery times for long-lead equipment. This delivery system yields similar benefits for early work that requires the engagement of specialized subcontractors.

Initially, owners and contractors relied on bespoke terms or agreements for the release of early work, such as limited notices to proceed. More recently, and in response to market demand, industry groups have developed form agreements that provide standard language for early procurement and early work releases, such as ConsensusDocs' 500 series of templates and the AIA's G735-2021 "Authorization to Proceed with Early Work," both of which were created for use with contracts employing a CMAR delivery system. The default AIA G735 template, in particular, authorizes the CM to proceed with early work or procurement even before the parties have negotiated and agreed to a guaranteed maximum price (GMP) for the project. This permits the CM to obtain materials and equipment pricing and delivery schedules as early as possible, maximizing savings and minimizing the schedule impact of these materials and equipment.

Strategy 4: increasing use of cost-plus and guaranteed maximum price contracts with contingency provisions

The traditional design-bid-build project system, often accompanied by fixed price payment terms, was the product of relatively stable pricing for construction materials and labor in previous decades. But the post-pandemic environment has accelerated the demand for more flexible payment arrangements. Here, too, sophisticated parties have resorted to the CMAR delivery system, which they ordinarily pair with cost-plus and GMP payment terms. Under these terms, the owner pays the CM for the cost of the work plus a fixed fee, both of which are subject to a not-to-exceed GMP "cap." Two features typical of this arrangement make it particularly advantageous in the current environment. First, this type of contract often includes a shared savings incentive, under which the owner pays the CM a percentage of any "savings" if the final cost of the work is below the GMP, thereby incentivizing cost-effective construction. Second, the parties typically include contingency allowances in the project budget, which cover costs attributable to unforeseen price increases or other conditions that might render performance of the work more expensive, thereby accounting for risk before construction begins.

The typical negotiation items for parties contemplating this type of arrangement include: (a) the amount of any contingency allowances in relation to the GMP; (b) whether those allowances are subsumed within the GMP, such that unused amounts then have the potential

to be shared savings; (c) whether the owner may (instead) wish to maintain an off-budget "project contingency" fund; (d) the circumstances under which the contractor may use any contingency allowance, which is often tied to the contract's definitions for *force majeure* or excusable delays; (e) the percentage of shared savings that the owner may split with the contractor; and (e) the timing and application of any shared savings agreement to materials procurement and subcontractor buyout.

Strategy 5: judicious use of liquidated damages clauses

Liquidated damages clauses are almost as ubiquitous in the commercial construction world as they are disliked by contractors. The increased risk of delays attributable to pandemic-related supply chain interruptions during the past few year has made these clauses all the more unpalatable to contractors, and contractors have increasingly resisted their inclusion in their contracts. Where the inclusion of liquidated damages provisions cannot be avoided, contractors have accounted for this increased risk in their price proposals or have attempted to pass this risk to their subcontractors and suppliers through flow-down provisions and other risk-shifting provisions. In this manner, the increased risk of liquidated damages may increase the costs of doing business in the industry, generally.

As an alternative, contracting parties are increasingly excluding circumstances attributable to excusable delays – including the pandemic and its numerous disruptions – from their assessment of liquidated damages. These exclusions take many forms, including more expansive *force majeure* and excusable delay clauses, as discussed above, and agreements to cap liquidated damages, often at an amount near the contractor's expected profit or fee for the project or, in any event, at a number not out of proportion with the commercial benefit the contractor expects to receive from the project.

Thus, while liquidated damage provisions are here to stay, thoughtful project owners and contractors are structuring them more judiciously, given inherent economic and commercial uncertainties in the current market.

Conclusion

Large capital and construction projects have always involved a certain level of intrinsic risk. However, the current environment has amplified this risk and created more significant pitfalls for the imprudent or unwary project participant. Now, more than ever, drafting contracts to account for difficult market conditions is essential for owners and contractors to navigate – and thrive in—these uncertain economic times. The above strategies are by no means a panacea, but are helpful tools to mitigate the risks of doing business in an increasingly uncertain world.

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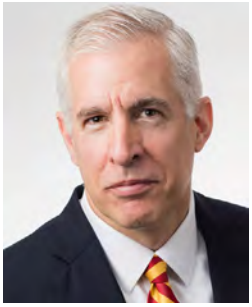

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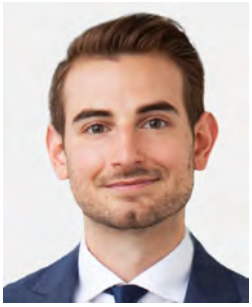

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Q&A with international arbitration lawyer Vanessa Thieffry

Tell us about your practice and the types of matters in which you are typically engaged?

My practice focuses on the resolution of disputes with a technical aspect – mainly construction and infrastructure, with an ever-increasing number of cases in the energy sector in the past few years. My intervention spans from project advisory work through claims management and dispute prevention if possible. And ultimately to arbitration, and the enforcement of the award (or conversely, its challenge). I am also developing an expertise in the resolution of disputes containing an environmental or social aspect, as these issues are and will continue to be on the rise.

In addition, I also act as an arbitrator, which gives me a vision from "the other side of the table" and has afforded me useful insights as to how best to present a case.

How much of your work is focused on domestic construction and capital projects work in France versus international projects?

I would say 30 percent domestic and 70 percent international. We tend to follow our clients on projects both in France and abroad, but most often with an international element or stakes of a magnitude generally seen in international rather than domestic projects. Also, notwithstanding the location of the project, I generally tend to assist clients that are either French, francophone or come from a civil law country.

What particular skill do you possess that you feel makes you unique or that allows you to provide value to the clients you serve?

I would say that I am a pragmatist and relish tackling delicate technical points and the challenge of presenting them in plain language to an arbitral tribunal.

Construction law/disputes-related questions

What are your clients most concerned about as we complete the first quarter of 2023 (i.e., what is keeping them up at night)?

European clients report focusing on the environmental impact of their activities, both externally and internally.

There are of course concerns about the environmental impact of construction projects, or producing products in compliance with local laws, but the trend goes beyond that: It has become a question of competitiveness and of reputation, with tenders now integrating points relating to the environmental and climate, social and human rights impacts of the project, completed plant, or product. There follow a number of issues in relation to conformity, fitness for purpose, measurement standards of the environmental impact of the construction or product, etc. In addition, these obligations generally apply not only to our clients, but also their entire supply chain.

The environmental impact of our European clients' activities is also a growing concern, due to recent evolutions in European law which create a set of compliance obligations in relation to sustainability. First, under Directive (EU) 2022/2464 of December 14, 2022 in relation to Corporate Sustainability Reporting (the "CSR Directive"), which entered into force on January 5, 2023, large companies must disclose both the environmental impacts of sustainability issues on their activities "outside-in" and the impacts of their activities on the public and the environment "inside-out," following the principle of "double materiality." Second, the "Taxonomy Regulation" 2019/2088 of November 27, 2019 seeks a level playing field through a coherent classification of activities contributing substantially to sustainability objectives: To characterize as sustainable, an activity must contribute substantially to one or more of six objectives (climate change mitigation and adaptation, protection of water and marine resources, pollution prevention and control, protection and restoration of biodiversity and ecosystems, and transition to a circular economy), and not do "significant harm" to any such objectives. Third, a proposed Sustainability Due Diligence Directive completes the scene by setting forth a framework for investigation, verification and publication of the impacts of a company's activity on sustainable development throughout its supply chain.

What steps do you see your clients taking to mitigate these concerns?

Again, a distinction must be made as to what they do externally as opposed to internally.

Our clients attempt clearly to define expectations as regards environmental and other relevant standards to be reached, to contractualize environmental and/or social baseline studies prior to the commencement of the works to assist in the establishment of a breach, if any.

Internally, they are used to dealing with compliance issues. The main difficulty resides in the scope of the compliance exercise, as it depends upon elements that are, in fact, beyond their control. First, the CSR Directive imposes liability to the reporting company not only on its activities, but also on those of its entire supply chain. Second, the companies' reports are more and more scrutinized by internal and public stakeholders, which causes great risks to their reputation, and has also led to suits being brought against them by citizens and NGOs, notably for greenwashing or contributing to climate change. This risk is much more difficult to harness, and requires constant attention.

What trends are you seeing emerging in the international arbitration cases on which you are working that you would like to pass along to other Reed Smith clients in the international arbitration space?

One trend is the increase and enhanced complexity of multi-tiered dispute resolution clauses. They already existed, but parties appear to harness more and more the various types of dispute resolution methods that exist, in the hope of resolving the dispute prior to the recourse to arbitration. For example, "fast and dirty" dispute resolution methods such as dispute boards and adjudication prior to arbitration are on the rise. However, as these other dispute resolution methods are increasingly used, parties are getting more and more sophisticated in their implementation, and attempting to abuse or circumvent the process, also increasingly, thus creating entirely new disputes with at times counterproductive effects.

Advice to clients in the face of economic uncertainty

Given the impacts on global construction from COVID, global supply chain disruptions and the war in Ukraine, what changes are you seeing being incorporated into contracts to address these disruptions?

With COVID and the war in Ukraine, we have seen multiple delay claims which have prompted force majeure claims. Affected parties are even attempting to use these events of force majeure to rebase or recalibrate the project – which is often in fact the renegotiation of an entirely new contract. As a result, parties have recently been more and more attentive to force majeure, hardship, and changed circumstances clauses. As force majeure entitles to time but not to costs, they also take great care with respect to any price adjustment mechanism, and have been seen also to attempt to incorporate in contracts signed with public or state owned entities, so-called stabilization clauses entitling them to renegotiate or terminate the contract should it become economically imbalanced, notably due to changes in taxes and duties.

In addition, compliance clauses are increasingly agreed upon. By the simple fact that performance under ESG factors is to be monitored throughout the value chain in accordance with the CSR Directive, and may give rise to claims or even termination if a partner does not comply or disclose properly, compliance clauses are and will become more and more extensive and stringent. This will also lead to new types of disputes to be litigated or arbitrated.

Are you hearing or seeing any evidence yet from your clients that the recent disruptions in the financial markets with certain U.S. and European banks are having an impact on your clients' upcoming capital projects plans?

No, not yet. But it will inevitably have an impact on the funding of projects. Watch this space…

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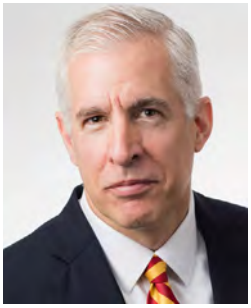

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Green transition set to fuel growth in France's construction industry

Against the backdrop of difficult economic times for the construction industry across Europe, France remains committed to environmental sustainability or the "green" transition of its construction sector, as a stimulus for growth and investment. According to France's Ministry of the Environment, the building sector currently accounts for 43% of France's annual energy consumption and generates 23% of France's greenhouse gas emissions. However, new laws and regulations are set to curb this trend.

The Decree of March 8, 2023 modifying the criteria of energy and environmental exemplarity (the "Decree of March 8, 2023") and the Ministerial Order of March 8, 2023 relating to the conditions that must be met in order to benefit from exceeding the rules of construction (the "Order of March 8, 2023").

The Climate and Resilience Act of August 22, 2021 (the "**Climate and Resilience Act**") gave the Mayor or the President of the local municipal corporation (EPCI) jurisdiction over urban planning, allowing them to "*issue building permits or take the decision* [not to oppose a] *prior declaration by authorizing construction projects demonstrating environmental exemplarity to derogate from the rules of local urban plans relating to height.*" This provision[4] aims to encourage green construction projects by allowing for increased height and density when buildings are exemplary from an environmental standpoint.

The Decree of March 8, 2023 and the Order of March 8, 2023 are intended to specify and apply this derogation from the rules of urban planning for construction projects claiming to be entitled to it.

They specify that the derogation may be authorized "*within the limit of an excess of 25 centimeters per level* [i.e., per floor], *and a total of 2.5 meters at any point above the height of the construction authorized by the regulations of the local urban plan*." It will then be necessary for project owners to justify "*technical constraints resulting from the use of a construction method that demonstrates environmental exemplarity and, for a given number of floors, leads to a height per floor greater than that resulting from other construction methods.*" However, the addition of an extra floor is prohibited.[5]

4 Article L. 152-5-2 of the Urban Planning Code
5 Article R.152-5-2 of the Urban Planning Code

In addition, the notion of "*environmental exemplarity*" has been simplified. It is sufficient that the construction achieves "*minimum results in terms of impact on climate change linked to the building's components and assessed over the entire life cycle of the building*." A document certifying that the project owner has taken into account the required environmental performance criteria must also be attached to the building permit application.[6]

The Decree of March 8, 2023 defines more precisely the technical criteria related to the definition of environmental exemplarity, based essentially on the greenhouse gas emissions over the life cycle of the building.

These two regulations therefore together specify the limits of the exemption, but also simplify the notion of "*environmental exemplarity*." The texts therefore allow builders to more clearly understand the conditions that must be fulfilled in order to benefit from an advantageous exemption from urban planning rules for their "*environmentally friendly*" projects.

Decree no. 2022-1588 of December 19, 2022 on the definition of types of use in the management of polluted sites and soils (the "Decree of December 19, 2022").

Since the Law on Access to Housing and Renovated Urban Planning) of March 24, 2014 (ALUR Law), project owners wishing to establish a new activity on land formerly used for regulated environmental activities (ICPE), accompanied by a change of use of the land, must brief an expert consultant who must in turn determine and certify the need to clean up the site. Project owners are then bound by the advice of the consultant.

The Decree of December 19, 2022 specifies and applies the requirements set out in the law, and in particular the provisions of the Climate and Resilience Act, imposed on developers of construction projects and formerly used to regulate environmental activities.

The Decree requires operators to define the future use of the site when the regulated facility is shut down. This is carried out in consultation with the Mayor or the President of the local municipal corporation (EPCI) with jurisdiction over urban planning, and with the owner of the land. The Decree also specifies the factor that triggers the obligation to have recourse to an expert by specifying the notion of "*change of use*."

There is a change of use when "*the proposed use type is different from the previous use type ... for projects with multiple uses,* [if] *at least one of the proposed use types is different from the previous use type* [when] *the proposed use type is the same as the previous use type but changes the so-called conceptual scheme … from that used in the intended memorandum ... for the definition of management measures,* [when] *the proposed use and the prior use are of another use ... but are different from each other*."[7]

In addition, when the future construction project is intended to accommodate "*vulnerable*" members of the public (such as young children, pregnant women, or the frail or elderly), the project owner must send a certificate guaranteeing that a soil study has been carried out and the needs of such vulnerable individuals have been taken into account in the design of the project, drawn up by an expert consultant certified in the field of polluted sites and soils on the basis of Articles L.556-1 and L.556-2 of the Environmental Code, as amended by the Climate and Resilience Act of August 22, 2021 (ATTES-ALUR), to the Regional Health Agency.[8] This certificate must also be sent to the regulator of industrial facilities, if the new site will contain any regulated facilities.[9]

6 Article R. 171-3 of the Construction and Housing Code
7 Article 10 of the Decree of December 19, 2022
8 Article 11 of the Decree of December 19, 2022
9 Article 12 of the Decree of December 19, 2022

The entry into force on January 1, 2023 of the Decree of January 11, 2021 on the energy performance criterion in the definition of decent housing in metropolitan France (the "Decree of January 11, 2021").

The Law of November 8, 2019 on energy and climate introduced a ban on owners of residential buildings from renting them out (i.e., from entering into a rental lease) when the maximum thresholds for energy consumption in the residence are exceeded. The objective is to oblige owners to renovate their buildings before renting them out in order to fight against "thermal flaws" (i.e., loss of energy by poorly insulated buildings).

A dwelling will now qualify as 'not fit for rent':

i. where there are obvious health and safety risks for the occupants;

ii. in the absence of facilities required for normal enjoyment of and living in the dwelling; or

iii. where the required thresholds of energy performance are not met.

The Decree of January 11, 2021, which came into force on January 1, 2023, sets the maximum threshold for final energy consumption of housing at 450 kWh/m2 for metropolitan France.[10] This measure therefore applies only to new leases entered into on or after January 1, 2023.[11]

From 2025, the least energy-efficient housing (G-rated) will be banned from being rented. From 2028, it will be the turn of F-rated properties to be prohibited, and finally E-rated properties from 2034. It will therefore be necessary for a large number of landlords to carry out energy renovation work in the coming years in order to continue to offer these properties for rent. As for developers, they will have to respect these thresholds when planning new build projects.

It follows that 2023 will be the first of many pivotal years in which "energy renovation" will be the focus of real estate and construction work in the residential rental sector.

The Order of February 28, 2023 modifying the specifications of eco-organizations in the extended producer responsibility sector for construction products and materials in the building sector (the "Order of February 28, 2023").

The AGEC Law of February 10, 2020 on the fight against waste and the circular economy entrusted certain eco-organizations with the free collection, sorting and recovery of waste generated by the construction sector.

This new sector is intended to set up "*the free collection by eco-organizations of building waste from companies in the construction sector, craftsmen and individuals*." The waste can thus be reused or recycled. The objective is to promote the circular economy of not only inert waste (such as earth, stone, aggregates, and concrete), which represents 75% of the total volume of construction waste, but also non-inert waste (such as rock wool, glass wool, glass, plaster, paint, and wood), which represents 23%, and finally hazardous waste, such as asbestos, which represents 2%.

The objective is also to reduce the risk of illegal waste disposal by taking back waste free of charge, to improve traceability, and to prevent the saturation of landfills by developing the recycling and reuse of construction waste.

In this respect, the Order of February 28, 2023 now recognizes the right of construction companies, as well as waste collection centers, to ask one of the approved eco-organizations to take charge of waste from their construction operations free of charge. Each eco-organization must "*undertake* to *provide its best efforts to take charge of this waste within a reasonable time … at no cost*" to the builder (Annex I of the Order of February 28, 2023).

10 Article 1 of the Decree of January 11, 2021
11 Article 2 of the Decree of January 11, 2021

The Order of February 28, 2023 aims to provide "*new solutions for both elected officials and the construction sector*" in order to reduce the consumption of resources by modifying the specifications of these eco-organizations.

According to the Ministry of Ecological Transition, it plans to "*cover the territory with collection points according to local needs*" but also to "*strengthen the accessibility of collection points according to the constraints of professionals*." Lastly, it will make it possible to "*desaturate the network of local authorities' waste collection centers*."[12]

Initially planned for 2022, the launch of this sector will be delayed by one year to allow for the setting up of the regulatory framework. The relevant decree is eagerly awaited because the construction sector produces 42 million tonnes of waste per year, which is the same as the waste generated by households.

From now on, construction companies, as well as waste collection centers that collect building waste, will be able to ask one of the approved eco-organizations to take care of building waste free of charge. Such a decree will therefore have, without any doubt, a positive financial impact for builders.

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12 Statement of the Minister of Ecological Transition of June 22, 2022

Thought leadership

Energy Explored podcast

Energy Explored covers the challenges of achieving a carbon-neutral global economy: cutting emissions of pollutants and setting up new energy systems. Reed Smith lawyers and guest speakers shed light on the most important trends in emissions control and new fuels. Tune in, as we follow the everevolving journey through the transition of energy.

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Trading Straits podcast

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Have a question?

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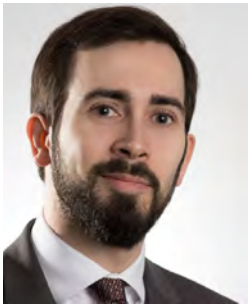

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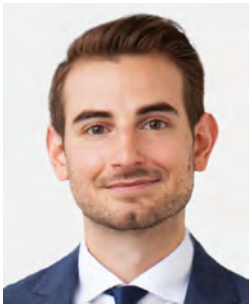

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