

# HOT TOPICS IN CONSTRUCTION ARBITRATION

28 July 2021 | Insight  
Legal Briefings

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With the pandemic still sending reverberations through the construction industry, we assess the post-Covid prospects for building disputes

The past year has been a turbulent time for the global construction industry, with many construction projects around the world having been affected in some form or another by delays, disruption and cost overruns arising directly or indirectly from the Covid-19 pandemic. Whilst there have been indications of a recent uptick in the global construction industry, many Covid-19 related disputes have yet to be resolved, and it is likely that the knock-on effect of such disputes, compounded by other pressing problems such as the global shortage in materials and workers, will increasingly be felt going forward. As government support schemes gradually come to an end, insolvencies in the construction sector are also expected to become a feature of the landscape.

That being said, there have been some positives to emerge from the last year. As with other types of disputes, parties and practitioners involved in construction arbitrations have been required to embrace remote working conditions, in particular virtual hearings, which have contributed significantly to furthering the greener and more sustainable arbitration agenda. Modular methods of construction, which have facilitated socially distanced working, have also continued to be in the spotlight.

In this article, Herbert Smith Freehills' Global Co-Heads of Construction Disputes, [James Doe](#) and [Hew Kian Heong](#), examine further how these global issues have impacted and/or are expected to continue impacting construction arbitrations going forward.

## CONTINUING EFFECTS OF THE COVID-19 PANDEMIC

In the wake of the Covid-19 pandemic, many international construction projects were impacted, albeit to varying degrees and at different times, by a range of Covid-19 related matters, such as government-imposed lockdowns, workforce shortages including a reduction in migrant workers, travel restrictions, pandemic related health and safety requirements, border closures and export restrictions.

In 2020, the initial focus of the construction industry was on whether or not force majeure provisions and change in law provisions in construction contracts would apply to these unprecedented circumstances and/or the doctrine of frustration (or equivalent principle in the relevant jurisdiction) could be invoked to relieve the parties from the adverse effects of the pandemic. At the time, the general trend was for parties to agree on short term fixes in the form of, for example, contractual variations and standstill agreements, rather than immediately to resort to formal dispute resolution.

This trend has also been seen in certain Asian jurisdictions, although with a key difference being that the short term fixes have been primarily government led. The Singapore government, for example, encouraged parties to negotiate and compromise, whilst providing extensive temporary legislative relief.<sup>1</sup> The Malaysian government also introduced a temporary legislative freeze on the ability of parties to exercise their rights in relation to their counterparties' inability to perform their contractual obligations, and established a specialised mediation centre to resolve disputes arising from government-imposed lockdowns.<sup>2</sup>

This government-led approach to mitigating the adverse impacts on construction projects and potential disputes has also been seen in China, with province specific guidelines being issued across the country, including on how parties should administer the increased cost of labour, materials, plants, and equipment arising from Covid-19. These have ranged from the employer bearing extra costs if the increase in material prices exceeds 5% (Guangzhou) to specifying the quantum for pandemic prevention costs, ie testing, quarantine, per worker (Shanxi).<sup>3</sup>

However, these short term fixes have also meant that the final resolution of many Covid-19 claims remains pending and important questions unanswered, for example, in relation to the assessment of the time impact of various social distancing and other Covid-19 related measures on the overall progress of the project. These issues have the potential to evolve into complex disputes with significant financial consequences, the resolution of which will be complicated in light of the unprecedented nature of the pandemic, but also given that reduced productivity claims are generally difficult to establish and depend heavily on the availability of good records of what was planned and what actually happened. Further, the longer such claims are left to fester, the harder they become to prove and likewise to rebut.

What is more, the economic impact of the pandemic is expected to make non-Covid-19 related claims more likely as projects become financially distressed which, in turn, increases the likelihood of parties resorting to arbitration. Even where all Covid-19 related claims on a project have been resolved, it is probable that these will have had a significant economic impact on the project, for example, by eroding margins and contingencies, so that the project is less equipped financially to deal with future challenges. Where a project is economically distressed, claims and disputes are invariably likely and parties may have no other option but to commence formal arbitral proceedings.

## **CONSTRUCTION INSOLVENCY**

In the UK, much to the surprise of many insolvency practitioners, there were apparently fewer insolvencies in 2020 than would have been expected in a pandemic free year such that, whereas between 2015 and 2019, construction insolvencies in England and Wales rose steadily reaching 3,228 in 2019, in 2020, the number of insolvencies dropped dramatically to just 2,042, which was the lowest number for at least a decade.<sup>4</sup>

This may, in part, be due to the fact that, in the UK, construction was one of the few sectors that was permitted to continue operating, albeit in a less efficient way due to restrictions such as those relating to construction site activity.<sup>5</sup> The general view, however, is that these unusually low insolvency figures are attributable to the billions of pounds pumped into the industry by the UK government in the form of the furlough scheme, government-backed loans and the deferral of tax payments such as VAT. According to the British Business Bank, the UK construction sector received the highest proportion of total Coronavirus Business Interruption Loans and Bounce Back Loans (17%), with £2.5 billion and £7 billion of loans offered respectively.<sup>6</sup>

Given the UK construction sector's dependence on government intervention, it is likely that insolvencies will begin to materialise soon after the UK government withdraws support, and loan and deferred tax payments begin to fall due.

Similarly, in Japan, corporate bankruptcies in 2020 fell to the fourth lowest number in 50 years, due to a range of pandemic response government cash flow assistance measures, with only 1,247 bankruptcies reported in the construction industry – a 13.6% decrease from the previous year.<sup>7</sup> According to the Research and Technologies arm of Mizuho Financial Group, government support prevented 397 bankruptcies in the construction industry in 2020.<sup>8</sup> As with the situation in the UK, however, it is likely that the number of bankruptcies will rise once government support gradually comes to an end. In this regard, it has already been reported that large scale bankruptcies have seen an increase in 2021, including in the construction industry.<sup>9</sup>

Where contractor insolvencies (or the risk of contractor insolvencies) begin to emerge, this typically leads to related disputes surrounding bond calls (which can, in turn, often lead to emergency arbitrations to resist the same) as well as termination claims.

# GLOBAL SHORTAGES IN MATERIALS AND WORKERS

Given the myriad obstacles that global trade has faced over the past 12 months (eg Covid-19 lockdowns which have caused understaffing and high shipping costs, uneven global trade, the Suez canal blockage, and lower plastics production following floods in Texas) the global shortage of construction materials such as timber, steel and plastics, and consequent increase in the cost of such materials, is hardly a surprise.

In the UK, the Office of National Statistics has predicted price rises of 7-8% across the board, but some industry bodies are reporting that prices for timber have gone up by 50% and cement by 30%.<sup>10</sup> The Dow Jones Steel Index has also increased by over 100% between June 2020 and June 2021. To date, in the UK, the brunt of these price increases has been felt by SMEs, as larger players have been able to stockpile and plan ahead. However, it is predicted that the effect of shortages will eventually be felt further up the supply chain, ultimately affecting major projects.

Region-specific problems have also played a part, such as in the UK, where the effects of Brexit have contributed, or are expected to contribute, to materials shortages. The impact of Brexit on the construction workforce is also starting to bite, with the UK construction sector losing a quarter of its EU workforce in 2020.<sup>11</sup> Further delays and price rises are expected to result from the introduction of post-Brexit certification rules, which will replace the European 'CE' trade markings with UKCA certification, and have been heavily criticised by industry leaders who say that the system does not have sufficient testing capacity and will disincentivise European suppliers from exporting to the UK.<sup>12</sup>

In Singapore, the impact of Covid-19 on the construction workforce has also been significant. Due to large outbreaks amongst migrant worker communities, most of which live in communal dormitories, construction came to a virtual standstill for at least two months in 2020, and more recently, due to tighter border measures which reduced the inflow of migrant workers, it has been reported that many Build-to-Order housing projects are expected to be delayed by a year or more.<sup>13</sup>

Further, materials shortages will likely be exacerbated as countries try to build their way out of the economic downturn following the Covid-19 pandemic. For example, whilst the final shape of the US Infrastructure Bill remains to be seen, the US government is expected to inject potentially up to US\$1 trillion<sup>14</sup> into the construction of roads, bridges and other public works. Similarly, the UK Government has already committed £600 billion to infrastructure investment over the next five years as part of its 'Build Back Better' programme. China has also launched a 'New Infrastructure' campaign to drive its economic recovery, with state media reporting that the investment in new infrastructure, which refers to digital facilities such as 5G base stations, vehicle charging stations, big data centres, artificial intelligence and industrial internet, could reach 17.5 trillion yuan, or about US\$2.47 trillion.<sup>15</sup> Although these ambitious measures will no doubt help the recovery of economies, they are also likely to place significant pressure on the demand and cost of raw materials.

Questions are bound to arise as to who bears the risk of shortages in materials and workers, and consequent price hikes under contract or at law. Some civil law systems may offer relief for undue economic hardship, although this is not always the case in other systems of law (for example, such relief is not generally available as a matter of English law). Therefore, assessing how the relevant construction contract addresses the risk of unavailability of materials (and/or increase in material costs) as well as workers will likely be a key focus of many parties going forward. However, similarly to the impact of Covid-19 (as described above), an increase in costs is, in any event, likely to place projects under greater economic stress which, in turn, may lead to a greater likelihood of claims and formal disputes arising.

## VIRTUAL HEARINGS

The global arbitration community in general was quick to adopt remote working practices, in particular virtual hearings, following the outbreak of the Covid-19 pandemic, with many arbitral institutions issuing guidance on how to mitigate the effects of the Covid-19 pandemic on arbitral proceedings<sup>16</sup> or updated rules<sup>17</sup> to reflect the 'new normal'. Similarly, construction arbitration players have embraced virtual hearings, which have had the added benefit of shifting the sector's dispute resolution practices towards a greener and more sustainable direction.

Now that virtual hearings have been tried and tested, parties to and practitioners of construction arbitration are likely to be increasingly conscious of the costs of in-person hearings (and meetings) when budgeting for disputes and may be more inclined to opt for virtual hearings going forward regardless of the lifting of Covid-19 related travel restrictions. The potential cost savings offered by virtual hearings, in particular as all parties concerned get more familiar and comfortable with them, will no doubt be a material consideration especially in the case of large and complex international construction disputes, which typically involve significant travel and accommodation costs to enable the tribunal, witnesses and legal teams to convene in the same place on multiple occasions.

However, the shortcomings of virtual hearings have also become apparent. Some professional bodies have been overtly critical of the experience offered by virtual hearings, with the Bar of Ireland, Bar Council of England and Wales, Bar Council of Northern Ireland and the Faculty of Advocates of Scotland jointly describing remote hearings as a '*markedly inferior experience*'.<sup>18</sup> The Korean Commercial Arbitration Board's Secretary General has also expressed that it is difficult to argue that virtual hearings can '*fully replicate the nuanced and instantaneous interaction between tribunal, counsel and witnesses which physical hearings can offer*'.<sup>19</sup>

Therefore, whilst virtual hearings are clearly here to stay, parties to construction arbitrations will need to consider very carefully how they are to achieve an appropriate balance between cost savings and the specific needs of the case. This may mean a more discerning way in which virtual hearings are used, for example, by reserving them for lower value or less complex matters and/or primarily for procedural hearings.

# MODULAR METHODS OF CONSTRUCTION

Modular construction methods continue to be a hot topic in the construction industry, and have increasingly been a hallmark of the most innovative construction projects. For example, the UK government has expressed an interest in investing in a Rolls-Royce-led consortium which plans to produce small nuclear reactors created from modules produced off-site.<sup>20</sup> Recently, Exyte, a German engineering group, created modular Covid-19 vaccine manufacturing facilities with a six month delivery time (whereas new permanent facilities can take years). Modular construction is also being recognised as providing the solution to the UK housing crisis. Elsewhere, in Hong Kong, a city record was achieved when factory assembled free-standing modules were installed on site to design and build 99 temporary Covid-19 quarantine units in just 77 days.<sup>21</sup> As recent modular projects demonstrate, the Covid-19 pandemic has propelled innovation and has brought about the shift to modular construction much quicker than might otherwise have been the case.

There is, of course, a long list of benefits to modular construction. An advantage that has been especially highlighted during pandemic times is that it facilitates socially distanced working by reducing the presence of workers on site and controlling social distancing in the factory setting where the module is being built. Proponents also advocate that it provides greater schedule certainty, less material waste and fewer delays.

However, as with all new technologies, modular construction is not without its risks. For example, the modular construction start-up Katerra, which was backed by SoftBank, filed for bankruptcy on 7 June 2021. It is understood that the bankruptcy was caused by spiralling costs and delays on several large projects.<sup>22</sup> In this regard, it is easy to see how delays and cost overruns can occur on a project involving modular construction: on complex projects with numerous interfaces, a module which does not work or fit could cause serious delays, especially if multiple versions of the same module are to be used across the site and extensive rework is required. In these circumstances, the programme will rarely be able to accommodate the resulting delays, especially if it is already under significant pressure (eg due to the continuing impact of the Covid-19 pandemic).

Whilst the industry's view remains that modular construction is the future, such disputes arising from projects involving modular construction can probably be expected as the technology finds its feet.

## CONCLUDING REMARKS

As we enter the second half of 2021, it is clear that challenging times are likely to continue, not only for the construction sector, but for the world as a whole. Although a sense of normality is gradually returning in some jurisdictions where governments have implemented national vaccine programmes, the global construction sector will likely be dealing with Covid-19 related claims for some time yet. Such claims may be further compounded by issues such as contractor insolvencies and materials and skills shortages. Despite these difficulties, however, it is also true that over the last year construction arbitration in the international context has taken a significant evolutionary step in embracing virtual hearings and normalising more sustainable practices. Whilst a balance will need to be struck, it will be incumbent on construction arbitration practitioners to sustain these positive changes.

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Listen to our Co-Global Heads of Construction & Infrastructure Disputes, James Doe and Hew Kian Heong, discuss the impact of virtual hearings on construction arbitrations, and the COVID-19-related challenges that remain for the construction industry [here](#).

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1. See <https://www.mnd.gov.sg/newsroom/press-releases/view/further-extension-of...> (temporary-measures)-actfor-specified-categories-of-contracts-in-the-built-environment-sector
2. See <http://www.pmc19.gov.my/en-index.html>
3. See <https://www.fticonsulting.com/-/media/files/apac-files/insights/articles...e43c26950e405697af9a3d7dafd968&hash=5932990BEDB46A2E5F4116FBEEA14513>
4. See <https://www.constructionnews.co.uk/financial/there-is-going-to-be-a-mass...>
5. See for example the Site Operating Procedures (at the time of this article, version 7 dated 7 January 2021) published by the Construction Leadership Council which reflect the UK government's guidance on 'Working safely during Coronavirus (Covid-19) - Construction and other outdoor work' in England.
6. See <https://www.british-business-bank.co.uk/coronavirus-loan-schemes-continu...>
7. See <https://www.tsr-net.co.jp/en/bankruptcy/2020.html>
8. See <https://www.mizuhogroup.com/binaries/content/assets/pdf/information-and-...>
9. See <https://www.nippon.com/en/news/yjj2021051001022/>
10. See <https://www.bbc.co.uk/news/business-57247757>

11. See <https://www.constructionnews.co.uk/brexit/uk-construction-loses-a-quarte...>
12. See <https://www.ft.com/content/11e49a14-5b89-4f23-ba47-2cde24dcd1ef>
13. See <https://www.channelnewsasia.com/news/singapore/lawrence-wong-impact-of-b...>
14. At the time of writing, President Biden was seeking US\$1 trillion in new spending, although this was being opposed by the Republican party who were offering just over US\$300 billion (see <https://www.reuters.com/world/us/us-house-will-start-infrastructure-bill...>)
15. See [http://www.xinhuanet.com/english/2020-05/21/c\\_139074719.htm](http://www.xinhuanet.com/english/2020-05/21/c_139074719.htm); see also HSF's e-bulletin on the New Infrastructure campaign: [https:// sites-herbertsmithfreehills.vuturevx.com/95/22666/june-2020/-new-infrastructure---china-s-massive-stimulus-measures-after-covid-19-outbreak- --part-1--internet-data-centres\(1\).asp](https://sites-herbertsmithfreehills.vuturevx.com/95/22666/june-2020/-new-infrastructure---china-s-massive-stimulus-measures-after-covid-19-outbreak- --part-1--internet-data-centres(1).asp)
16. See ICC guidance dated 9 April 2020
17. See 2020 Update to the LCIA Rules which took effect from 1 October 2020
18. See <https://www.lawsociety.ie/gazette/top-stories/remote-hearings-have-multi...>
19. See <http://arbitrationblog.kluwerarbitration.com/2020/04/06/safeguarding-the...>
20. See [https://www.rolls-royce.com/innovation/small-modular-reactors.aspx#/;](https://www.rolls-royce.com/innovation/small-modular-reactors.aspx#/) <https://www.ft.com/content/d7016b80-e0c4-4444-a059-2daf32b9a4ab>
21. See <https://www.lwkp.com/project/sai-kung-outdoor-recreation-centre-temporar...>
22. See <https://www.ft.com/content/a70b6130-b062-4850-8759-4a10a5a26f3d>

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