

Construction Disputes in Project Financing: Managing Conflicts of Interest Between Project Parties

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Introduction

Project finance structures commonly involve project parties, such as construction contractors, suppliers, offtakers and O&M contractors, who are affiliated to a sponsor or help secure debt for the project from their home-country's export credit agency or even provide loans directly to the project company. These relationships are often essential to a successful project financing and are even perceived as beneficial, since they encourage multiple project parties to pursue the common goal of a successful and profitable project.

However, when the project doesn't go to plan, the potential or actual conflicts of interest inherent in these relationships can harm the project and restrict the project company's ability to fully exercise its rights. These challenges are particularly pertinent during the construction phase of a project, when the project company is subject to large expenses and does not have a source of income. This article will examine these relationships from the perspective of the project company in the context of construction disputes.

Construction disputes

It will be the project company's aim to have its project delivered on time, on budget and in accordance with agreed specifications. However complex construction projects do not always run smoothly. Very rarely will a project be completed without encountering issues that lead to delays and changes in scope and cost. Delays and changes have real financial consequences and, therefore, disputes are a fact of life.

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Contractual milestone dates and times for completion will be missed and may lead to project company claims for delay damages (unless a contractor can argue that it should be entitled to an extension of time). It is also common for disputes to arise about the quality of a contractor's work – which might be resolved during a project by correction or remedy or afterwards in claims for breach of contract – and for payment disputes to arise in relation to variation, change or set-off. One likely effect of the global coronavirus (COVID-19) pandemic will be to increase the number of disputes in the sector as parties seek extensions of time or suspensions of works.

Parties to construction contracts commonly agree to resolve their disputes by forms of alternative dispute resolution and, ultimately, arbitration. Disputes from the construction sector make up a significant percentage of reported arbitrations. For example, in each of 2017, 2018 and 2019 (the most recent years for which such statistics are currently available) disputes from the construction sector made up around a quarter of the total number of cases filed with the ICC International Court of Arbitration.^[1]

Typically, construction contracts will contain provisions allowing the parties to make claims for extensions of time or additional payments. These often fall to be resolved by fair determination of the project company prior to escalation through a contractual dispute resolution process, if necessary. The majority of construction contracts will require forms of alternative dispute resolution prior to arbitration. Tiered dispute resolution clauses often include management discussions and / or expert resolution. At each stage of a dispute resolution process conflicts of interest may arise between stakeholders.

Other remedies may also be available to a project company. Contractors will often be obliged to provide security against their performance of the contract, upon which a project company can call. The most powerful remedy that a project company has against a contractor is the right to terminate a contractor's contract, although it is a step which requires careful consideration as the consequences of a wrongful termination can be serious.

In the context of a project financing, the project company should also be aware of its obligations under the finance documents. For example, taking certain actions during the dispute resolution process may require lender consent, which could also give rise to potential conflicts of interest.

Whether or not a dispute between the project company and contractor progresses to adversarial proceedings or can be resolved before that stage, any dispute is likely to raise tensions between the various stakeholders within a project finance structure containing affiliated parties. Given the likelihood of disputes arising during the construction phase of a project, it is important to be aware of the various conflicts of interest which can exist within a stakeholder group and to seek upfront to mitigate the problems these conflicts of interest can give rise to.

Key conflict of interest relationships

In the context of project financing construction disputes, the key relationships to consider are: (i) a sponsor and an affiliated construction contractor; (ii) a sponsor and an affiliated construction subcontractor; (iii) lender and an affiliated construction contractor; and (iv) an export credit agency (ECA) and a construction contractor.

(i) Sponsor – Construction Contractor

The most common potential conflict of interest is where the construction contractor is affiliated to one of the sponsors. The construction contractor's group is an obvious candidate to invest equity in a project, given their extensive involvement in it. In addition, given the equity investment, the construction contractor might be more willing to agree to favourable contractual terms that are conducive to securing project financing.

To avoid conflicts of interest, the shareholder or joint venture agreement will usually restrict the construction contractor's sponsor affiliate from making decisions about the construction contract, especially in the context of disputes. However, these restrictions are rarely full-proof. The construction contractor's sponsor affiliate will usually still be privy, directly or indirectly, to the project company's dispute management strategy, it will have copies of the sponsors' completion obligations and access to the financial model. If the construction contractor gains access to this information, it could be used to weaken the project company's dispute strategy. Moreover, during the course of complex construction disputes, the decisions required from the sponsors will extend beyond the dispute itself and may encapsulate matters such as taking actions to mitigate the impact of the construction delay or disruption or securing additional funding. The construction contractor's sponsor affiliate is unlikely to be excluded from these decisions, and may use veto or other powers in relation to these decisions to influence the outcome of the dispute with the construction contractor.

(ii) Sponsor – Construction Subcontractor

Many of the works involved in the construction of a major project are subcontracted by the main construction contractor. Delay or disruption during the construction phase is likely to be related to, or even the direct result of acts or omissions of construction subcontractors. Construction disputes between a project company and a construction contractor are therefore likely to be accompanied by disputes between the construction contractor and its subcontractors.

Where the subcontractor is affiliated to a sponsor, that sponsor may be tempted to intervene in the contractor-subcontractor dispute or even influence the terms of the project company-contractor dispute to improve the position of its affiliated subcontractor. A savvy construction contractor may also try to use the dispute with the subcontractor to improve its position in the dispute with the project

company. In addition, to the extent a sponsor or the project company intervenes in the contractor-subcontractor relationship, this can negatively impact the legal rights and remedies of the project company under the construction contract.

(iii) Lender – Construction Contractor

When there is no sponsor – construction contractor relationship, it is less common for the construction contractor to become a direct lender to the project. However, the construction contractor may in some cases and sectors (such as the oil and gas sector) decide to lend to the project company even in these circumstances, for example in the form of contingent loans to help manage potential cost overruns and ensure the bankability of the project.

These loans should be fully subordinated to the senior loans and the construction contractor's enforcement rights heavily restricted, especially during the construction phase, to avoid the construction contractor leveraging its rights as a lender in case of a construction dispute. However, if the settlement of a construction dispute necessitates a restructuring of the financing of the project and the terms of the contractor's loan also need to be amended as part of that restructuring, the construction contractor may use its leverage in that situation to help improve its position in the construction dispute.

(iv) ECA – Construction Contractor

The other relationship to be aware of under this heading is that of the construction contractor and its home-country's ECA. The ECA will often be an influential senior lender and, as an independent lender, will not be subject to restrictions on the exercise of its voting rights, including in relation to construction disputes. However, in most cases the ECA will have an existing relationship with the construction contractor across multiple projects and will have only participated in the project because of the construction contractor's involvement.

ECAs generally have strict policies that require them to exercise discretions independently and not to support other project parties, either directly or indirectly, in case of a dispute between the project company and that project party. However, even where such formal measures exist, the potential impact of the ECA-construction contractor relationship cannot be discounted. The ECA's opinion on what constitutes a fair settlement of the construction dispute will be an important consideration for the project company, especially where the outcome of the dispute may pose an existential threat to the construction contractor and the ECA would not want to be seen to contribute to the insolvency of a national champion.

Mitigation and management

Notwithstanding these challenges, affiliated project parties are often essential to a successful project financing and are not likely to disappear any time soon. The starting point for mitigating the impact of these relationships in the

construction context will be to minimise the potential for construction disputes. Measures such as ensuring the FEED is comprehensive and realistic, implementing effective oversight of the construction contractor, incorporating early warning signs into the construction contract to help address issues before they become material and a clear and simple contractor liability regime, including liquidated damages and performance bonds, can help reduce the number and extent of construction disputes. However, the potential conflicts should also be addressed in the broader context of the project financing, including:

- **Contractual measures outside the construction contract:** during the structuring phase it is important to evaluate how these relationships might impact the project company, discuss them with counterparties and address them in the relevant documents. This may include restricting a party from voting or influencing the outcome of decisions where a direct conflict of interest arises, providing that related discretions should be exercised 'acting reasonably' and preparing bespoke mechanisms to deal with specific scenarios that are likely to arise in case of a dispute. In the finance documents, giving the lenders' technical advisor a prominent role in guiding the lender group's decisions in case of construction disputes can help establish an objective yardstick.
- **Due diligence:** the relationship between affiliated project parties should be part of due diligence undertaken at the structuring phase. For example, what information barriers (if any) exist between the affiliates, do they operate independently of each other or ultimately report to the same decision-maker (for example, the CEO) and how have other conflicts of interest been managed by these affiliates in the past.
- **Balanced risk allocation:** ensuring a balanced allocation of risk between the different project parties can also help minimise disputes and conflicts of interest. For example, imposing disproportionately strict obligations on the construction contractor may seem like a good idea for the project company initially. However, it could backfire if the construction contractor agreed to those obligations because it believed its affiliation with a sponsor would mean those obligations would not be enforced (or not be enforced in full) in practice. This belief may be held notwithstanding that project financing agreements will typically contain provisions requiring project companies to enforce their rights under the project documents.

Once a dispute arises, the potential conflict of interest relationships should be evaluated early on, including the contractual terms applicable in the circumstances, how these conflicts might impact the dispute and what tools are available to the project company to ensure that it can act in its own best interests. This evaluation should be revisited regularly and addressed on a case-by-case basis.

In conclusion, it is very difficult in practice to completely avoid having affiliated project parties. However, with proper planning at the structuring phase of the project and effective management during a dispute, many of the negative impacts can be successfully mitigated. These lessons are also relevant to project parties other than the project company, including sponsors, finance parties, contractors, suppliers and offtakers. Each party should conduct its own analysis and ensure that its interests are fairly protected.

[i] 2017 ICC Dispute Resolution Statistics

2018 ICC Dispute Resolution Statistics