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Commercial and Construction Disputes Arising from COVID-19

Following the first reports of acute respiratory syndrome in China at the end of 2019, Chinese authorities have identified a novel coronavirus as the main causative agent. Since then, countries around the world have imposed containment measures and social distancing policies in an attempt to slow the spread of the virus. The outbreak has continued to evolve into a global threat and on 11 March 2020 the World Health Organisation declared COVID-19, the disease caused by the novel coronavirus, a global pandemic.

The spread of COVID-19 has become one of the biggest challenges to the global economy and financial markets, causing mounting disruption to businesses, their supply chains and severely curtaining international travel for both business and leisure.

The extent of the disruption will affect companies' abilities to meet their contractual obligations, potentially triggering disputes across a range of industries and sectors. Much has been written by law firms about the contractual provisions and risk management strategies companies can use to manage and minimise these disputes. In this article, we consider issues that could arise when quantifying losses in commercial and construction disputes arising from COVID-19.^{1,2}

As explained further below, specific challenges arise relating to:

- projecting the claimant's cash flows in such a rapidly changing environment;
- assessing the claimant's discount rate given the significant volatility in financial markets; and
- documenting the delay and / or disruption caused to construction projects by the outbreak.

¹ The views expressed herein are those of the authors and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals. FTI Consulting, Inc., including its subsidiaries and affiliates, is a consulting firm and is not certified public accounting firm or a law firm.

² This article focusses on the economic and financial consequences of the pandemic and its implications for damages quantifications. This is not intended to dismiss or diminish the pandemic's enormous human and social costs.

Lost profits in commercial disputes

For the purposes of the discussion regarding losses in commercial disputes, we have assumed that a respondent has been found liable for breach of contract and that liquidated damages, or other contractual measures of loss, do not apply. In such circumstances, losses in a breach of contract dispute are typically assessed as either lost profits (expectation losses) or wasted costs (reliance losses).³ The complications introduced by COVID-19 are likely to be greatest in claims for lost profits, which are the focus of this article.

Lost profits are measured as the difference between:

- the cash flows that the injured party expects to earn as a consequence of the alleged breaches, the “Actual Scenario”;⁴ and
- the cash flows that the injured party would have earned ‘but for’ the alleged breaches, the “But For Scenario”.

These scenarios can be assessed using a discounted cash flow (“DCF”) analysis. In a DCF analysis, the claimant’s estimated cash flows in the Actual Scenario and the But For Scenario are projected over a discrete period from the date of breach to the estimated end of the loss period. The cash flows in each year are then discounted back to the assessment date using a discount rate that reflects the riskiness of these cash flows. A DCF analysis therefore relies on credible projections of the claimant’s cash flows in the Actual Scenario and the But For Scenario and a reliable estimate of the discount rate applicable to those cash flows.

Even in conventional breach of contract disputes, both of these elements can be subject to considerable debate between the parties. Due to the extent of the disruption caused by COVID-19, parties are likely to face additional challenges assessing cash flows and discount rates in disputes arising from the current crisis.



Cash flow complications

On the cash flow side, the outbreak complicates the projection of cash flows in the But For Scenario. For example, consider a hypothetical dispute between a smartphone manufacturer (as claimant) and a member

of its supply chain (as respondent) over an alleged failure to supply smartphone displays, that resulted in the termination of a supply agreement.⁵

Under normal circumstances, one might reasonably assume that had the contract been performed, the claimant would have taken possession of the displays and used them to manufacture smartphones, which it would then have sold to customers. When considering the But For Scenario the valuer could reasonably use the claimant’s historical price and cost data to estimate the incremental profit the claimant would have earned on these sales.

However, given the level of disruption caused by the outbreak, it is unlikely that a shortage of displays was the only factor affecting the claimant’s business at this time. To construct a plausible But For Scenario, a valuer may need to consider whether the outbreak has affected the claimant’s business more widely.

For example, the outbreak may also have caused a shortfall in other inputs used in the manufacturing process, such as other raw materials and labour, and/or closures of the claimant’s factories. In these circumstances a valuer would have to consider whether the claimant would have been able to manufacture the smartphones, even if the displays had been available, and at what cost. The claimant’s historical manufacturing costs may be an unreliable guide to the manufacturing costs it would have incurred during the outbreak.

The valuer would need to work with counsel to develop the appropriate But For Scenario. In constructing this But For Scenario it may be necessary to consider how to treat a situation in which the manufacturer has suffered multiple breaches of its supply agreements, each of which in isolation would have caused the manufacturer to suffer some loss but which have cumulatively resulted in far greater losses. In such a situation, the Judge or Tribunal will need to balance the risk that the claimant will not fully recover its losses (if each loss is treated individually) against the risk that the respondent is held liable for damages not attributable to its breach (if losses are treated collectively). To assist the Judge or Tribunal, valuers and counsel will need to clearly set out the how they have treated multiple breaches and the damages implication of that treatment.

³ Other measures of loss, such as Wrotham Park damages, are outside the scope of this article.

⁴ Although disputes professionals typically refer to “lost profits”, valuers typically assess losses based on cash flows. Profit is the difference between revenue and expenses, measured according to accounting standards. Cash flow is the cash flowing in to and out of the business.

⁵ It is also possible that disputes will arise from a manufacturer’s refusal to accept delivery of goods, if it is unable to store these goods or use them in its manufacturing processes due to factory closures or shortages of other materials.

The outbreak may have also affected demand for the claimant's products, and the claimant's ability to meet that demand. Preliminary data published in Q1 2020 indicated that smartphone sales in China fell by over 50% in February 2020, compared to February 2019. On 1 February 2020, Apple closed all 42 of its retail stores in China. These stores were reopened by 13 March 2020, though some were operating with reduced hours. On 13 March 2020, Apple announced that it would be closing all its stores outside of Greater China.⁶

In constructing a But For Scenario, a valuer will need to consider whether the claimant could have sold its products and at what price. Historical demand and price data may be of limited use in addressing these issues. The valuer may need to perform more complex economic analyses to estimate demand and compare that estimated demand to the claimant's estimated inventory levels. Moreover, the outbreak's medium- and long-term economic effects remain unclear, increasing the challenges associated with developing cash flow forecasts for the life of a supply agreement.

Finally, many jurisdictions require a claimant to take reasonable steps to mitigate its losses. When projecting a claimant's profits in the Actual Scenario, a valuer may need to consider whether and how the outbreak has affected the claimant's ability to mitigate its losses over the intended life of the contract.



Discount rate complications

The wider financial consequences of the outbreak also complicate assessments of the discount rate applicable to projections of a claimant's cash flows in both the Actual and But For Scenarios. Valuations are often very sensitive to changes in the discount rate: a one percentage point increase in the discount rate, from say 9% to 10%, may reduce value by 10% or more.

Valuers typically estimate the discount rate using the Capital Asset Pricing Model, or CAPM. The inputs to this model are often estimated using financial market data such as government bond yields and stock market returns. Projecting cash flows is a forward-looking exercise and in principle the inputs selected to assess the

discount rate should reflect expected conditions over the forecast period. However, the outbreak has contributed to significant volatility in financial markets and current conditions may not reflect expected conditions over the entire forecast period.

For example, the first stage in applying the CAPM is to identify the appropriate risk-free rate, i.e. the rate of interest earned on a bond that is free of default risk, reinvestment risk, inflation risk and liquidity risk. In practice, the risk-free rate is often based on the yield to maturity of long-term sovereign bonds of the US or a small number of west European countries.

Historically, the yield on 10-year US treasury bonds has fluctuated between 2% and 5%, with a long-term average of approximately 3%.⁷ However, recent weeks have seen yields far below these long run averages, while the yields on the sovereign bonds of some European economies have turned negative. Some valuers have suggested that in such circumstances some of the inputs to the CAPM, notably the risk-free rate and the equity market risk premium, should be normalised to reflect conditions that are expected to prevail over the life of the cash flow projections. Others consider that the CAPM measures the opportunity cost of investing at the assessment date over a certain horizon and should therefore be based on the market returns available as at the assessment date.

Regardless of the approach the valuer adopts, it is important to ensure that the inputs to the CAPM are internally consistent. For example, the equity market risk premium tends to move in the opposite direction to the risk free rate, offsetting some of the effect of changes in the risk free rate. Therefore, it would not be appropriate to use a normalised risk-free rate together with an equity market risk premium based on spot market conditions and vice-versa.

Construction projects

Another area of business that is facing significant disruption from COVID-19 is the construction industry. Regionally, many countries rely on imported labour for construction projects. With governments around Asia first tightening immigration controls and then closing their borders to incoming foreign travellers, the workforce for most construction companies has come under significant strain.

⁶ Source: Apple's statement dated 13 March 2020.

⁷ Source: Board of Governors of the Federal Reserve.

Additionally, with China playing such a large part regionally in the supply of materials, from glass and steel, to curtain walling and HVAC, even where labour shortages can be mitigated, delayed delivery of materials can have a similar disrupting effect on works.

Contractors and employers therefore need to understand their contractual rights and act accordingly. It is important to ensure that the right contractual clauses are used when making claims for additional time and / or money under the contract. For instance, whilst a Force Majeure clause will potentially provide the contractor with recourse in relation to time, it will not usually give entitlement to recovery of additional costs. However, a clause for adjustments for changes in legislation could potentially provide entitlement to both time and costs if a government has changed the laws as part of their measures to combat COVID-19.

A further, and major, consideration is that whilst a contract may give potential entitlements, it would still have an obligation to demonstrate that the claimed events actually caused delay, disruption and / or additional expenditure. In order to do this effectively, the contractor will need to show the effects of delaying events through critical path analysis and possibly measured mile analysis. In order to demonstrate delay and / or disruption, contemporaneous records are going to be required as back up to the claims. It is therefore essential that such records are kept in sufficient detail.

As COVID-19 continues to disrupt supply and distribution chains across the world, many companies will find themselves unable to fulfil their contractual obligations, and potentially in dispute with their counterparties.

The damages issues in these disputes are likely to be conceptually similar to those that disputes professionals see routinely and which can be addressed using standard techniques. However, the level of disruption caused by the outbreak introduces additional complexities to the implementation of those standard techniques. It is important that parties and valuation experts engage with these complexities when presenting damages assessments to Courts and Tribunals. A failure to do so may undermine the parties' chances of securing a fair outcome in its disputes.

FTI is here to help

The experts in our Construction Solutions and Economic Consulting practices have decades of experience dealing with complex issues of value, delay and loss. We at FTI are here to assist you and your team with analytical challenges relating to both time and cost issues as well as loss assessments arising as a result of COVID-19.

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