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Termination of Construction Contracts

Recently, we have been involved in the termination of several high-profile construction contracts. The purpose of this update is to provide a refresher of the key characteristics of termination and to explore the likely consequences of such an event.

In construction contracts, it is commonplace to refer to the right that flows from breaching a condition, repudiating a contract or fundamentally breaching the contract as a right to terminate. However, there are important differences in the consequences that arise from rescission and termination. For example, rescission treats the contract as if it had never existed, whilst termination discharges the parties from any future obligations.

Where a contract is terminated for breach, repudiation or frustration, the contract is discharged either as a whole or partially terminated.

Contractual Right of Termination

Ordinarily, construction contracts will outline the grounds upon which either party may terminate and the steps that ought to be taken to achieve lawful termination.[1] More specifically, most standard form construction contracts make provisions that allow for termination upon the occurrence of specified breaches of the contract, such as any of the following:

(a) Insolvency

(b) Unlawful suspension of works by a contractor

(c) Consistent failure by an employer to make payment

A contractual right to terminate is often the preferred method of ending a contract, as it provides certainty as to the procedure to be followed by the aggrieved party. Typically, a contract will require a series of notices to be issued by the complainant prior to termination.[2] These notices are to be followed by a grace period, allowing the defaulting party the opportunity to remedy the breach before termination of the contract becomes effective.

The contract will generally stipulate the form, content, timing and mode of service of a notice to terminate, with conflict between terminating parties most commonly arising over whether the prescribed steps were followed. Therefore, it is essential that parties properly adhere to the contract's process of termination so as to mitigate the risk of claims being brought for wrongful termination.

1 *Holland v Wiltshire* (1954) 90 CLR 409.

2 *Hyundai Heavy Industries Co Ltd v Papadopoulos* [1980] 2 All ER 29.

There are three main ways that a contractual right allows for termination in construction contracts. These include:

1) Automatic Termination

A contract can be automatically terminated in situations where there is an express term to terminate the contract on the occurrence or non-occurrence of a specified event.[3] Such contracts should stipulate the events giving rise to a right of termination with sufficient specificity.

In construction contracts, insolvency is the most commonly specified event that allows for automatic termination by way of an *ipso facto* clause.

2) Default

The most common contractual rights of termination in construction contracts are for specified breaches of the contract.

Upon the occurence of a specified breach, the defaulting party is usually given a cure notice requiring that either:

(a) The breach be rectified within a certain period of time

(b) The defaulting party show cause as to why the contract should not be terminated

The right to terminate the contract will only arise upon the defaulting party failing to adequately act or respond to the notice in the manner required by the contract. However, the terminating party must adhere to the contractual provisions when terminating the contract to ensure they are not seen as repudiating the contract.[4]

3) Convenience

In large scale construction contracts, it has become more common for one of the parties (usually the principal) to hold the right to terminate at their discretion. This discretion usually has no limitation on when or in what circumstance a termination for convenience clause operates. However, case law suggests that, in the absence of clear warning, exercising a termination for convenience clause simply to obtain a better price to complete the works from another party would amount to a breach of contract.[5]

3 See for example: *New Zealand Shipping Co Ltd v Société des Ateliers et Chantiers de France* [1919] AC 1.

4 *Diploma Construction Pty Ltd v Marula Pty Ltd* [2009] WASCA 229.

5 The High Court has not yet settled whether Australian contract law should recognise an implied duty of good faith into contracts. However, in *Carr v Berriman* (1953) 89 CLR 327, the High Court held that a contract's variation power in absence of express wording did not permit a principal to omit works to provide to another contractor for a more attractive price.

When terminating for convenience, it is usual for the terminating party to compensate the other party for costs expended and profits made up to the date of termination, the costs of breaking arrangements with other parties, as well as any demobilisation costs.

Common Law

In cases where there are no express contractual termination clauses, termination is still available where one party has committed a repudiatory breach. In circumstances of this kind, the aggrieved party is entitled to terminate the contract immediately and claim damages.

Repudiation

A repudiatory breach is one that goes to the root of the contract, frustrates the commercial purpose of the contract or deprives the non-defaulting party of substantially the whole benefit of the contract.[6] Certain types of breach will amount to a clear repudiation of the contract including an absolute unlawful refusal to carry out work, abandonment of the site or failure by an employer to give access to the site. Other breaches, including delay by the contractor, may not amount to a clear repudiation of the contract and largely depends upon the facts of the case.

Repudiation by one party will not, of itself, end further contractual obligations. A right to terminate for repudiatory breach is conditional upon the aggrieved party not affirming the contract. With this in mind, it is generally recommended that in order to avoid inadvertently affirming the contract, the aggrieved party should not delay in commencing the process of termination, nor should it continue to act under the contract. Rather, the aggrieved party should promptly notify the defaulting party in writing to confirm that it is terminating the contract and do nothing further in relation to its own obligations under the contract.[7] If this is done correctly, both parties are released from performance of their unperformed obligations and damages are payable to the party at fault.

Damages for repudiation aim to put the aggrieved party in the position it would have been had the contract been properly completed. If the aggrieved party does not accept the repudiation, it affirms the contract and the contract will continue, with the possibility of damages being claimed for the breach. Further, the aggrieved party will likely pursue its contractual entitlements (e.g. for unpaid monies).

Breach of an Essential Term

It is well established that simple breaches of a contract will not create a common law right to terminate.[8] Therefore, in order to terminate a construction contract, the term must be an essential term by way of being a condition of the contract or a non-essential term that has caused substantial loss.[9] A condition is a term in the contract that is of such importance that the promisee would not have entered into the contract without assurances that the term would be strictly adhered to.[10]

Traditionally, essential terms in construction contracts deal with timely performance of works or services and outline how payments are to be made in a timely manner. However, these essential terms may also be implied under common law if the contract does not explicitly contain them.

A breach of an essential term of a contract does not automatically terminate the contract, but creates a right to terminate by the non-breaching party. The party with that right must decide whether to terminate (by providing written notice of immediate termination) or continue to keep the contract 'on foot', while reserving the right to be paid damages for the breach.

Frustration

Frustration of a contract occurs when neither party has defaulted on the contract but other circumstances have prevented the contract from being performed as originally intended. In order for the contract to be frustrated, further performance of the contract must be impossible, illegal or radically different from what the parties contemplated when they entered into the contract.

If frustration of the contract has occurred, the contract automatically ends and all future obligations of the parties are discharged.

Exclusion of Common Law Right of Termination

A common law right to terminate is presumed to exist unless there is an express term excluding such a right in the contract.[11]

Statutory Right of Termination

A statute can create rights to terminate a contract or impart certain conditions, which, if breached, may create a right to terminate as if those conditions had been written into the contract.

Consequences of Termination

In some cases, albeit rarely, a contract will allow for rescission, which, upon termination, treats the contract as if it never existed. Rescission of a contract rarely occurs in present day construction contracts, and usually only arise where something invalidates the contract from forming.[12]

Where rescission takes place, the contract is set aside to (as nearly as possible) restore the parties to their original position prior to entering the contract. The parties will therefore have no accrued rights or obligations under the contract.

An alternative to rescission, and more common in construction contracts, is a right to determination, which relieves the parties from performing their future obligations under the contract.[13] This means that the parties are still liable for their breaches pre-termination, with some contracts specifically prescribing that certain obligations are to continue post-termination, including any limitations on liability and indemnities.

If a party terminates a contract, it is likely that it will seek to recover any additional costs that flow from the breach of the defaulting party that led to the termination event.

6 *Hong Kong Fir Shipping Co. Ltd v Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26.

7 *Heyman v Darwins Ltd* [1942] AC 356, 361.

8 *Bentsen v Taylor Sons & Co* (1893) 2 QB 274, 281

9 *Koompahtoo Local Aboriginal Land Council v Sanpine Pty Ltd* [2007] HCA 61.

10 *Tramways Advertising Pty Limited v Luna Park (NSW) Pty Ltd* (1938) 38 SR 632.

11 *Commonwealth of Australia v Amann Aviation Pty Ltd* (1991) 174 CLR 4.

12 *Highfield Property Investments Pty Ltd v Commercial & Residential Developments (SA) Pty Ltd* [2012] SASC 165.

13 *McDonald v Dennys Lascelles Ltd* (1933) 48 CLR 457, 469-470.

Conclusion

Given the increased number of construction contracts being terminated (for whatever reason), and the significant consequences flowing from such events, it is as important as ever that parties understand their rights, risks and obligations prior to commencing contractual relations. Equally, if you find yourself in a situation comparable to any described in this update, it would be prudent to seek legal advice in order that your rights and entitlements are best protected.

Squire Patton Boggs is listed in the First Tier for Construction & Infrastructure Lawyers by Doyle's Guide 2017.

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