Termination in construction projects

It is essential that the right to terminate is exercised correctly. Getting it wrong (which happens all the time) can have disastrous consequences.

Wrongful termination when terminating contractually
A party that purports to operate a contractual termination clause, when it is not entitled to do so, may repudiate its contract. This is because a party who acts on a contractual termination clause usually ceases to perform its own obligations. Incorrect termination in itself may be a fundamental breach.

If the termination was invalid, and the other side has accepted your repudiation by leaving the site, you may be liable to the other side for damages for wrongful termination.

If a contract is wrongfully terminated, a party can be expected to receive the full contract value of any work done at that time, less sums previously paid, and possibly a sum for loss of profit on the remaining works. It is important to remember that if you subsequently discover your mistake, you cannot simply restore the contract without the agreement of the other side.

Selecting the best commercial approach is a dilemma for a party — whether to risk a wrongful repudiation, with all its consequences, or play for safety by continuing the performance of the contract and relying only on the right for damages.

In view of the risks, how do you go about protecting your position when terminating a contract?

Check the grounds for termination
• Check that the grounds can be proven. The circumstances in which a right to terminate arises must be shown to exist for the notice to be valid.

A wrongful termination made in respect of a breach which has not, in fact, occurred can, in some circumstances, be justified by proof of another breach existing at the time of the wrongful termination.

• Do the facts of your situation fall within the specific grounds for termination allowed for in your contract?
• Can the grounds of termination on which you are relying be said to be your fault? If so, you are opening up a potential ‘can of worms’, as there is a general legal principle that a party cannot benefit from its own wrong.

It is important to note that many of the JCT forms of contract require a party not to act “unreasonably” or “vexatiously” when exercising a right to terminate the contract. There is some guidance that assists the parties in judging if these factors have been satisfied. For example, the recent case of Reinwood Limited v L.Brown and Sons [2008] UKHL 12 gives six principles to help assess whether a party has acted unreasonably or vexatiously. These include that a “vexatious” termination is where a party terminated the contract with the ulterior motive or purpose of pressing, harassing or annoying the other party and that the test of what is “reasonable” is to be determined by looking at how a reasonable contractor would have acted in all the circumstances.

Check the procedure for termination

Look at the exact mechanisms for termination. Exact compliance with the procedural requirements laid down in the termination clause will usually be required otherwise the termination may be found to be wrongful.

Check the time limits and service requirements for termination notices. In general, provisions specifying a particular mode of service are directional, not mandatory.

Where the contract specifies who is to give and receive a notice, it must be given and received by the correct person otherwise it may be invalid. This may be important where, for example, a preliminary notice is to
be given by the architect or engineer, but the actual notice of termination is to be given by the terminating party itself.

A related point is that the contract often provides for a preliminary or warning notice followed by a notice of termination if the default is not remedied. There must be a reasonable connection between the initial and subsequent notices. It is not possible for a preliminary notice to be served, followed by a notice of default some considerable time afterwards, in circumstances where the recipient might not reasonably connect the two notices as relating to the same matter.

Thus, in Architectural Installation Services Ltd v James Gibbons Windows Ltd a preliminary notice was served requiring a default to be remedied. A notice of determination was given 11 months later. It was held that where a contract provides for two notices to be served, that termination will only be valid if an ordinary commercial businessman could see that there was a sensible connection between the two notices both in content and time. This test was not satisfied in this case.

Exercise the right ASAP

It is important that you exercise the right to terminate within a reasonable period, otherwise you may waive your right to terminate by having “affirmed” the contract. The courts like certainty when it comes to resolving legal disputes. Accordingly, there is a point at which parties can be forced to draw a line under a breach and move on. To do otherwise could expose the opposite party to the continuous threat of termination for years after a breach.

If you wait too long, therefore, to decide whether or not to pull the plug, you might find the decision has already been made for you. It seems even clauses in the contract that give you as long as you like to make up your mind will not help you.

Tele2 v the Post Office

Take the recent case of Tele2 v the Post Office [2008] EWHC 158 (QB), which emphasised the importance of certainty when terminating a contract. Tele2 committed a material breach of its contract. Nobody disputed the fact that this was a material breach but the Post Office waited 11 months before purporting to terminate the contract. Given the delay in seeking to terminate, Tele2 argued that the Post Office had lost its right to end the agreement.

Tele2 relied on something called the doctrine of affirmation, which states that if you know about a breach that gives you the right to terminate, you must decide whether to do so before “the law takes the decision out of your hands”. Tele2 said that allowing the contract to run for another 11 months implied that the Post Office, as far as the Post Office was concerned, it did not matter how long it waited, it could still terminate at any time. Indeed, the Post Office pointed to its “non-waiver” clause – a provision in many construction contracts that states delay in exercising a right will not prevent enforcement at a later date.

However, the Court of Appeal did not agree. In its opinion, continuing with the contract for 11 months was more than just postponing the exercise of a right – it was such clear evidence of the Post Office’s intention not to terminate, it said, and that the only possible conclusion was that the contract remained in force.

What we learn from this case is that if a party does want to keep its options open in response to a breach, it must “protest” and “reserve its rights” in a way that the Post Office failed to do. Promptly notifying the other side of its potential breach and spelling out that you are reserving your rights would seem to be a step in the right direction.

Tips to strengthen your position when terminating contractually

- When in doubt as to whether breaches are “material” carefully consider the impact of the breach on your business and record this contemporaneously.
- Consider when to exercise a termination right. For example, a failure to proceed “regularly and diligently” will generally be easier to allege towards the end of the contract than at the beginning.
- Another tip – what happens if you do omit to serve a termination notice, or if the other side puts right the default within the required time?

Well, you cannot terminate at that point. However, if the other side then repeats the same default for which the initial default notice was served, there is a helpful provision in the JCT contracts that means you do not have to go back to the beginning and start the termination procedure afresh.

Instead, you will be able to terminate then and there or within a reasonable time of the repetition of the default. However, if you do exercise this procedure, the default must be the same default for which the first notice was served.

- A final point in terms of contractual termination is that even if you do not have a valid contractual termination, your termination may still be valid at common law.

A good example of this is when a main contractor terminated a subcontractor wrongly by sending an initial default notice and 11 months later, without further warning, sought to terminate the contract.

The court held that the second notice did not constitute a valid contractual termination since a reasonable person would have seen no connection between the two notices, but it was held to be a valid termination under common law.
Termination under common law

Unless the contract stipulates otherwise, a party will have the right to terminate under the contract or under common law. Indeed, the JCT suite of contracts makes it clear that contractual provisions for termination are in addition to any other legal rights of the parties.

In some circumstances, it may be more profitable to terminate under common law than under contract, as acceptance of a repudiatory breach under common law gives rise to damages, whereas termination under the contract simply entitles the party to whatever remedies the contract stipulates.

How do you go about terminating under common law?

Firstly, you must accept the other side’s repudiatory breach of contract. No matter how serious the breach of contract is, unless there has been a clear and unequivocal acceptance of the breach, the contract will not be terminated. It will generally be sufficient if there is some communication or conduct that shows the repudiating party that you are treating the contract as at an end.

Clearly, it is better to record the acceptance of a repudiatory breach in writing.

Get the timing right, particularly having regard to the previous course of dealings. In particular, a sudden termination without adequate warning or without previously making known the exact nature of the complaint may be very risky.

Tips to strengthen a termination under common law

- Consider making time of the essence - it can be helpful to make it a condition that the other party’s obligations be performed by a certain date.
- Write to the other side setting out why you consider them to be in repudiatory breach. If the other side gives an inadequate or no reply, this may strengthen your position that the breach is repudiatory.
- Verify whether the other party has performed or taken steps to perform its obligations.
- Ask the other side for evidence that it is able to perform its obligations.

Damages for wrongful termination

If you do get it wrong, and you terminate wrongfully, what are the potential consequences?

A party that has been wrongfully terminated is entitled to be placed in the position it would have been in if the contract had been completed without breach. The normal measure of damages protects a party’s expectations under the contract, which should entitle a party to receive payment under the contract for work done, together with loss of profit on work not done.

Secondly, termination frequently involves seizure or use of plant. Where the termination turns out to be wrongful, the terminated party will naturally be entitled to damages for any plant seized by the other side.

N.B. A party that has accepted the wrongful repudiation of a contract is not restricted to suing for damages for breach of contract. A party may, as an alternative, elect to treat the contract as rescinded on a quantum meruit basis. This would be of advantage if the contract rates had been low or not economical.

However, it is important to note, that on a quantum meruit basis, a party would not be entitled to a separate claim for loss of profit.

When faced with a termination notice

Do:
- establish internal reporting systems to ensure that only senior management is authorised to communicate with the other side as regards any purported termination;
- commence a contractual dispute resolution procedure, if there is one, to tie the customer into continuing to perform pending resolution of the termination dispute;
- consider the possibility of commercial settlement (for example, re-profiling, re-pricing or deferral of, or negotiated exit from, obligations).

Don’t:
- accept notice of termination - instead contest it and expressly reserve the position;
- waive a potential breach by the customer (for example, a defective notice).

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