

# Employer termination of a construction contract

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## Termination under Swiss law Potential pitfalls of termination Comment

Terminating a construction contract is the last resort for employers frustrated by delays, defects or other problems. Three recent Supreme Court cases illustrate some of the pitfalls of termination for employers. In all three cases, the employers' attempt to terminate for cause was construed as termination for convenience, exposing the employers to significant liability towards the contractors, including for lost profits.

### Termination under Swiss law

Under Swiss law, an employer has the right to terminate a construction contract in various situations.

For instance, an employer can elect to terminate if the contractor fails to meet the completion date (Article 107(2) of the Code of Obligations). However, if there is no fixed completion date in the contract, the employer must first fix a deadline for completion of the works and notify the contractor before it can terminate. The employer can also refuse to accept the works and seek damages if:

- they are so defective that they cannot be used; or
- the employer could not equitably be expected to accept them (Article 368 of the Code of Obligations).

Prior to the completion date, an employer has two possible courses of action open to it in case of delay or defects (Article 366 of the Code of Obligations):

- It can terminate the contract if:
  - the contractor does not commence the works on time;
  - the contractor delays the performance of the works in a manner contrary to the contract; or
  - the contractor's delay is such that there is no longer any prospect of completing the works on time.
- It can hire a substitute contractor if it is possible to "predict with certainty" that the works will be performed in a defective manner or a manner contrary to the contract. Merely establishing the existence of defects in the works will not suffice.

The defects must be sufficiently serious such that the contractor cannot be expected to remedy them before completion.

Where the conditions for a termination for cause are not met, an employer's termination will be considered a termination for convenience. Under Swiss law, an employer may terminate for convenience at any time prior to completion; however, it must then compensate the contractor for the loss of the remaining portion of the contract, including lost profits (Article 377 of the Code of Obligations).

Swiss law on termination is not mandatory and will often be displaced by the terms of a contract. For

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instance, the International Federation of Consulting Engineers (FIDIC) Conditions contain detailed provisions on termination by employers, identifying specific grounds, conditions and consequences for termination. However, Swiss law will remain relevant to interpreting these provisions and to filling in any gaps. For example, unlike Swiss law or the 2017 Red Book, the 1999 Red Book does not expressly require the employer to compensate a contractor for lost profits and other damage in the event of a termination for convenience under Clause 15.5. It merely cross-refers to another provision that mentions compensation only for completed works and other expenses incurred or to be incurred by the contractor. The interface between such provisions and Swiss statutory law, and more specifically the question of whether the contractor would nevertheless be able to seek damages for lost profits under Swiss law, will have to be assessed in light of the specific circumstances of each case.

## **Potential pitfalls of termination**

The potential pitfalls of employer termination are well illustrated by three recent cases before the Supreme Court.

The first case (4A\_273/2017, 14 March 2018) dealt with the installation of a hardwood floor. The employer, a homeowner, suspended the works well before completion on the grounds that they were seriously defective. The parties agreed to jointly seek the opinion of an expert, who concluded that the floor as installed was unusable and had to be entirely replaced. On this basis, the employer purported to exercise her right under Article 368 of the Code of Obligations to refuse works on the grounds that they were so defective that she could not use them.

The employer went on to initiate proceedings against the contractor to recover the cost of hiring a substitute contractor to redo the works. The first-instance court appointed its own expert, who took a different view than the initial expert: he opined that although the partial works had been performed in an unorthodox manner, it would have been possible for the contractor to properly complete them. It was only after the employer had suspended the works that the partially installed floor became unusable, due to the contractor's failure to remove temporary wedges that subsequently caused the floor to heave and deform.

Both at first instance and on appeal, the courts ruled that the employer could not rely on Article 368 of the Code of Obligations to refuse the works, as they had not yet been completed. The courts also excluded the applicability of Article 366 of the Code of Obligations, which allows an employer to hire a substitute contractor prior to completion if it is possible to predict 'with certainty' that the works will be performed in a defective manner. According to the opinion of the court-appointed expert, no such prediction could be made. As a result, both the first-instance and the appellate courts concluded that the employer's actions amounted to a termination for convenience under Article 377 of the Code of Obligations, entitling the contractor to payment for the performed works and full compensation for the remaining works. This conclusion, which was not reviewed by the Supreme Court, appears to be somewhat harsh, as the employer had relied on an expert opinion commissioned jointly by the parties.

The employer nevertheless ultimately managed to avoid liability as the contractor had breached its obligation of diligence by failing to warn the employer of the risk of leaving the temporary wedges in place. This aspect of the case was the subject of the appeal to the Supreme Court (for further details please see "[Contractors' obligation of diligence and duty to inform persist even after termination](#)").

Another recent Supreme Court case (4A\_491/2017, 24 May 2018) involved an arbitral award rendered in a dispute over the delivery of machines for repairing rails. The Supreme Court's decision merely considered the narrow grounds for annulment of arbitral awards under Swiss law. However, the arbitral tribunal's award, the content of which is reported in the Supreme Court's decision, is an important cautionary tale for employers. The contract in the case, which was categorised by the tribunal as a contract for works akin to a construction contract, contained a clause allowing the client to terminate in the event of any delay in delivery of more than 90 days. The client exercised this right after the manufacturer had failed to meet a delivery milestone. However, the tribunal ruled that the delivery milestones in the contract were merely targets, not fixed deadlines. As a result, the tribunal found that, in accordance with Swiss law, the client should have first notified the manufacturer of its default and set a fixed deadline for delivery, which it did not do. The tribunal thus

ruled that the client's termination amounted to a termination for convenience pursuant to Article 377 of the Code of Obligations, entitling the manufacturer to compensation.

The third case (4A\_525/2017, 9 August 2018) dealt with the construction of the headquarters of an Algerian public entity by a Canadian contractor. The contract allowed the employer to terminate if liquidated damages for delay reached an aggregate amount of 10% of the contract price. After a dispute arose concerning the contractor's delay, the employer exercised its right to terminate the contract. However, the arbitral tribunal ultimately ruled that the delay for which the contractor was responsible was not sufficient to reach the 10% threshold. As a result, the tribunal found that the employer's termination amounted to a termination for convenience under the applicable Algerian law, and that the contractor was entitled to lost profits. However, the tribunal reduced its award of lost profits because the contractor had unjustifiably refused to vacate the site for three years following termination, an aspect of the decision that was later upheld by the Supreme Court.

## **Comment**

These three cases show that employers should be mindful of potential pitfalls when considering termination. An overly hasty or otherwise ill-considered termination could prove to be costly. In all three cases, the employer was potentially exposed to significant liability after its attempt to terminate for cause was found to amount to a termination for convenience. Ultimately, the relevant facts, the terms of the contract and how those terms interact with Swiss law will be decisive.

In many cases, termination for cause will be possible under either the contract or supplementary Swiss law (to the extent that non-mandatory law is not displaced by the terms of the contract). For instance, in the case of irrecoverable delay or serious defects, employers are in principle entitled to terminate or replace the contractor (Article 366 of the Code of Obligations). Even if a termination is construed as one for convenience, contractors will often not be awarded full damages for the termination if they are in breach of contract. Indeed, in two out of the three cases discussed above, the tribunal reduced or excluded the employer's liability after finding that the contractor had breached the contract.

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