

Construction - Switzerland

Right to rescind: delayed and unfulfilled construction contracts

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Introduction

In a recent decision,⁽¹⁾ the Supreme Court confirmed that an owner may rescind a contract for works if the contractor is in default. Before doing so, the owner must – as a general rule – put the contractor on notice and grant it a reasonable grace period to remedy its default. In the present case, the contractor failed to reach agreed-upon output requirements and its delivery of the works was late. The court held that no prior notice or grace period was required in these circumstances. However, the court confirmed that an owner must always inform a contractor immediately and unambiguously of the termination. The court found that the owner's declaration of the termination was unambiguous, despite the fact that the owner had led negotiations with the contractor after the rescission.

Facts

In December 2007 a contractor undertook to automate the production line of a manufacturer of chocolate moulds, which had until then been made by hand. The contractor designed a production line, the delivery and handover of which was agreed to take place on April 30 2008. Subsequently, this delivery date could not be met and the parties rescheduled the pre-acceptance/pre-inspection test and final acceptance for May 19 and June 6 2008 respectively. On the contractor's request, the pre-acceptance test was again postponed to May 21 2008. On that date, it became obvious that a timely delivery and installation of the machine at the owner's premises would not be possible, as additional time was needed to modify the machine further in order to increase its output.

In a letter dated June 10 2008, the contractor informed the owner about the envisaged modifications and promised delivery of the equipment in the week commencing June 30 2008. In the same letter, the contractor informed the owner that the output would be limited to 14 or 16 moulds per minute, depending on the type of mould being produced. The contractor stated that "with our design, we unfortunately do not see any possibility to further increase the output quantity".

In a letter dated June 12 2008, the owner stated that the contractor had neither complied with the agreed delivery date nor met the contractual output requirements. Subsequently, the owner rescinded the contract through a letter dated July 9 2008.

The contractor filed suit against the owner and requested payment of Sfr370,000 as compensation for the work already performed. The contractor argued that the owner was not entitled to rescind the contract without first:

- putting it on notice; and
- granting it an appropriate grace period for performance.

The commercial court, however, dismissed the contractor's claim and the Supreme Court further rejected its appeal.

Decision

In the proceedings before the commercial court, the issue of what the contractual output requirements actually were, and at what point in time they had to be met, was disputed

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between the parties. The contractor, whose design allowed production of 16 moulds per minute, argued that the contractual output requirements varied between 16 and 18 moulds per minute depending on the kind of mould. However, the owner argued that the contract required an output of 18 moulds per minute regardless of the type of mould being produced. While the relevant contractual provisions are not reproduced in the Supreme Court's decision, the decision indicates that the commercial court concluded that the contractor had guaranteed an output quantity of at least 18 moulds per minute, regardless of the type of mould being produced. In arriving at its conclusion, the commercial court primarily considered the fact that when manufacturing the chocolate moulds by hand, the owner could achieve an output of 14 moulds per minute. According to the commercial court, it had to be assumed that, by automating the production line, the owner sought to significantly increase this output. The court also relied on the contractor's conduct after the conclusion of the contract: the contractor had, in several communications and tentative production plans, described how it intended to reach an output of 18 moulds per minute.

The Supreme Court ruled that the issue of when the production line had to meet the guaranteed output requirements (either at the pre-acceptance/pre-inspection test or at the delivery and final acceptance date of the work) was irrelevant given that the contractor had confirmed in writing that it would not be able to increase the output further.

The commercial court had already established that the date for the final acceptance of June 6 2008 lapsed without delivery. Thus, the contractor was in default when the owner rescinded the contract.

The contractor argued that rescission was unlawful since the production line was 87% completed (only minor modifications and the erection of the production line on the owner's premises were pending). In case of minor defects, Article 368(2) of the Code of Obligation does not permit an owner to rescind a contract. The only remedy available is a reduction in price or repair (for further details please see "[Remedies for contractor's refusal to repair defective works](#)"). However, the contractor had not raised this argument before the commercial court and, therefore, the Supreme Court refused to consider it. The Supreme Court confirmed that Article 366 of the code grants an owner a right to rescind a contract for works at any time where the contractor is in default. This is merely a reflection of general Swiss contract law, which affords a creditor the right to rescind a contract upon the debtor's default (Articles 102 to 109). The court further confirmed that Article 366, and the remedies which it provides for, must be read and applied in accordance with these general rules of Swiss contract law.

Relying on these general rules of Swiss contract law, the contractor argued that before rescinding the contract, the owner should have issued a formal notice and granted it an appropriate grace period for performance as required by Articles 102(1) and 107. The Supreme Court rejected the contractor's first argument by concluding that the parties had explicitly agreed on specific dates for pre-acceptance and for delivery/takeover. Pursuant to Article 102(2), the debtor is automatically in default on the expiry of an agreed fixed deadline even without any reminder or notice letter.

Regarding the contractor's second argument that it had not been granted an appropriate grace period for subsequent performance as required under Article 107, the court referred to Article 108(1), according to which the granting of a grace period is not required if:

- it is evident from the debtor's conduct that a grace period would be futile;
- performance has become useless to the creditor as a result of the debtor's default;
or
- the parties stipulated that performance must take place at or before a specified time.

The Supreme Court rejected the contractor's argument, since the contractor had clearly confirmed in writing that it would be unable to increase the output of the production line and thus comply with the contract. Thus, a grace period would have been "useless" as per Article 108(1) of the code.

Further, the Supreme Court highlighted that unless the contract is an absolute fixed-term contract, under which performance after the contractually specified time is no longer possible, the rescission must be declared immediately and unambiguously. In the case at hand, the contractor claimed that rescission was not only untimely but also ambiguous, since the parties continued to discuss the conditions for an acceptance of the production line and further design modifications. The court found that, in the circumstances, such negotiations were irrelevant. The rationale behind Article 107 is that the contractor should not be left in any doubt as to whether it should incur further costs in trying to fulfil the contract. In the present case, the contractor had not undertaken any steps in that regard and had even confirmed that, in its view, performance was not possible.

Therefore, the Supreme Court upheld the commercial court's decision and confirmed that in the specific circumstances at hand, the owner was entitled to rescind the contract without formally notifying the contractor beforehand and without granting a grace period for subsequent performance.

Comment

What conclusions can owners and contractors draw from the above decision? First, the decision shows that parties should specify any output requirements with precision and state explicitly when such requirements must be met. Sanctions for failure to fulfil any of the output requirements should also be specified.

Second, in case of delay or defective performance, a contractor should carefully consider any statements it makes in its communications with the owner. If a contractor believes, for instance, that delay or defects are the owner's fault or that they are otherwise excused, it should clarify this. Unqualified admissions by a contractor that its own design renders performance impossible may considerably restrict its defence against the owner's remedies.

In addition, if a contractor believes that the works are substantially completed or that only minor items remain open, it should inform the owner accordingly. Under Article 368 (2) of the Code of Obligation, rescission of a contract is possible only in exceptional circumstances.

Similarly, an owner which considers that the contractor's works are defective or that the contractor is in delay should immediately verify what statutory and contractual remedies are available to it, and when and how they must be exercised. Any communications with the contractor at this stage should be drafted with care, as statutory and/or contractual form and content requirements may apply (eg, immediacy, unambiguity and irrevocability). Some of these requirements may be mere formalities, while others might be prerequisites for the legal validity of the communication. In general, an owner will first have to put the contractor on notice and grant a time limit for performance before it can exercise the statutory or contractual remedies (typically remediation, rescission or reduction of remuneration). Only in exceptional circumstances, as in the case at hand, can the owner dispense with its obligation to notify and grant a grace period.

Statutory remedies in case of default are not mandatory. Swiss law allows parties to agree on available remedies, as well as on how such remedies should operate.

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Endnotes

(1) Supreme Court decision of September 20 2011 (4A_232/2011).

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