THE HIDDEN TRAPS OF TERMINATING CONTRACTORS

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A show cause/termination regime is found in nearly all construction contracts. At first glance, it all appears fairly simple and innocuous. Typically, the contract provides that if the contractor breaches defined provisions of the contract, such as time for performance, the owner may issue a notice to show cause, requiring the contractor to remedy the breach. If the contractor fails to do so within a specified period of time, the owner may then either terminate the contract or take the works out of the hands of the contractor.

However, the courts have imposed various restrictions on the rights of owners to terminate construction contracts in accordance with this contractual mechanism. In particular, they have imposed an implied requirement for the owner to act reasonably at various stages in the process.

These restrictions will undoubtedly flow to other industries which use similar contractual regimes for the termination of contracts, such as contracts for professional services in most industries, including engineering, legal and IT consultants.

The effect of these restrictions is usefully illustrated by an example. Suppose a contractor is six months late in completing a building project. During the six months of delay, the parties may have been involved in continuous negotiations to attempt to overcome the delay or minimise its effects. However, at some point the owner's management decides to initiate the show cause regime and subsequently to terminate the contract.

In doing so, the owner may unwittingly expose itself to a *quantum meruit* (reasonable price) claim — the promised land for many contractors — or damage for breach of contract.

This is because if the contractor can show that the owner's attempt to terminate was unreasonable, the owner's conduct will amount to a repudiation of the contract, entitling the contractor itself to terminate the contract and either recover a *quantum meruit* or, alternatively, sue for damages for breach of contract.

Such a claim by a contractor may arise for myriad reasons, but usually involves:

- a failure by the owner to comply with conditions that have to be satisfied before a notice to show cause may be issued;
- defects in the form and/or substance of the notice to show cause;
- a failure to reasonably consider the contractor's response to a notice to show cause; and/or
- after reasonably considering the contractor's response, a failure to reasonably consider whether or not to terminate the contract or take the works out of the hands of the contractor.

PRE-CONDITIONS

Show cause provisions usually provide that before a notice to show cause may be issued the contractor must have been in substantial breach of the contract.

Substantial breaches are generally defined in the contract, and almost invariably include a breach of the provisions in the contract concerning time for performance.

An owner may initially have the impression that if a project is (say) six months late, this will be a substantial breach by the contractor. However, there may be a number of other explanations for the delay. For example, the

delay might be caused by a failure by the owner's consultants to provide design information or the performance of substantial variation work.

Before issuing a notice to show cause, owners should therefore make independent enquiries to ascertain the causes of the delay.

If the owner or its consultants have been responsible for the delay, any purported termination by the owner will amount to repudiatory conduct, entitling the contractor to terminate the contract itself and recover either a *quantum meruit* for the work performed to that date or, alternatively, damages for breach of contract.

Frequently, show cause provisions also provide that before a notice to show cause may be issued, the principal must have considered whether damages would be an adequate remedy for the breach by the contractor.

To satisfy this pre-condition, it seems likely that the owner must be able to demonstrate, at least subjectively, that damages may not be an adequate remedy.

For instance, if a building project is six months late and the owner has already sold or leased the building and must provide occupation to the new owners or leaseholders, damages may well not be an adequate remedy for the builder's failure to complete.

Conversely, if the owner has no obligation to grant access to new owners or leaseholders, even though the project is six months late it is arguable that damages may be an adequate remedy.

DEFECTS IN THE NOTICE

It may seem trite, but it is important for owners to ensure any notice to show cause is in the proper form and strictly complies with any requirements of the contract.

For instance, the contract may require a notice to show cause to:

- specify that it is a notice to show cause issued under a particular provision;
- specify, with some particulars, the breach complained of; and
- give the builder an opportunity to respond within a specified period of time and at a specified place.

There are a number of court decisions to the effect that if the owner fails to comply with the specified requirements the notice will fail, even if the contractor was otherwise in breach, and any termination based on the notice will be repudiatory conduct.

REASONABLE CONSIDERATION OF THE CONTRACTOR'S RESPONSE

Most termination regimes simply provide that if the contractor fails to show cause, the owner may terminate the contract.

Superficially, nothing could be clearer. But what is the standard to be applied in judging the contractor's response?

This standard became a hidden peril in 1992. Since then, the NSW Court of Appeal has held, on more than one occasion, that a power to terminate must be exercised reasonably, and specifically that an owner must give reasonable consideration to the question of whether the contractor had failed to show cause.

This requirement is frequently referred to as the first limb of *Renard*, this being the name of the decision which first espoused the principle [*Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234]]. It is onerous and has several facets.

Not surprisingly, by the time an owner decides to activate the show cause/termination regime — and particularly if any negotiations with the contractor have broken down — it has often already made the decision to terminate the contract. Thereafter, the owner may only be giving lip service to the regime, while proceeding to engage another builder and taking other steps to complete the works.

However, a breach by the contractor, even a substantial breach, is not enough, by itself, to permit the owner to terminate. The owner must give the builder an opportunity to respond to the notice to show cause, and must carefully and reasonably consider the response. If it does not, its conduct in attempting to terminate — even if otherwise meritorious — will amount to repudiatory conduct.

To take another example of the principle, if a builder admits in its response to a notice to show cause that there have been delays for which it was at least partly responsible, but says it is taking steps to alleviate these delay by increasing resources or productivity or taking some other step, it is arguable the builder has in fact shown cause.

Similarly, if the builder explains that the delays were caused by acts of prevention by the owner or its consultants, and adequately explains these delays, it is likely that the contractor has shown cause, rendering any purported termination by the owner unlawful.

REASONABLE CONSIDERATION OF WHETHER TO EXERCISE THE POWER TO TERMINATE

Even after an owner has reasonably determined that a contractor has failed to reasonably respond to the notice to show cause, the owner is still required to reasonably consider:

- whether to exercise its power to either terminate the contract or take the works out of the contractor's hands, and if so
- which of these powers it should exercise.

This requirement, often referred to as the second limb of *Renard*, can be more difficult than the first to satisfy, as it may not be readily apparent to the owner what matters it must take into account.

Some of the factors an owner should bear in mind in this regard are:

- whether any delay would be exacerbated by the delays associated with engaging a new contractor and the new contractor's learning curve. Would it be more reasonable to keep the original contractor and thus minimise the delay?
- the project's status. If it is close to completion, it is unlikely to be reasonable for an owner to terminate the contractor. Conversely, if the project is anything less than (say) 80% complete, it may be argued that it was not unreasonable to terminate.
- the costs which would be incurred by the owner in completing the works, compared to the amount payable to the existing contractor. Often, a new contractor will only take over a distressed project on the basis of a cost-plus arrangement. While it would not necessarily be unreasonable to engage a new contractor on this basis, it might be if the likely costs of completing far exceed the contract sum remaining to be paid to the original contractor.

CONCLUSION

The mere fact that a contractor is in substantial breach of a contract does not, of itself, entitle an owner to terminate.

Owners considering their options concerning a defaulting contractor need to take care to comply with the express and implied provisions of the show cause/termination regime. If they do not do so, they may be exposed to a *quantum meruit* claim or substantial damages.

To minimise the risk, owners in this situation should seek professional and legal advice on the steps they should take.

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