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Exercising the Right to Terminate – Why Your Default Notice Matters

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The right to terminate a construction contract for reasons such as poor performance is a crucial contractual right. However, if exercising the right to terminate is not carried out in accordance with the contractual notice requirements then a party risks invalidly terminating the contract, and exposing itself to a wrongful termination action. Recent case law in the UK and Australia serves as a timely reminder that a valid or invalid termination can start with the contractual "default" notice.

Default Notices and Termination

Many contracts require a "default" notice before a termination notice is issued. A default notice alerts a party to the reasons why the other party believes that the party is in breach of contract. The default notice requires the party receiving it, within a stated amount of time, to take steps to remedy the identified issues on a project and / or to explain why the party is not, or is no longer, in breach of contract. The primary aim of a contractual notice regime is to provide a party in breach the opportunity to remedy the notified breach and to avoid termination. If the issues persist then default notices become part of the necessary contractual requirements for a valid termination.

Recent Cases – Failure to Issue and Inadequate Default Notices

In the recent English High Court (Technology and Construction Court) decision, *Interserve Construction Limited v Hitachi Zosen Inova AG* [2017] EWHC 2633 (TCC), the Court considered the application for declaratory relief by Interserve Construction Limited (**ICL**), a design and build subcontractor, to *Hitachi Zosen Inova AG* (**HZI**), an EPC contractor, for the construction of an energy-from-waste plant in Hartlebury, Worcestershire. HZI sought to terminate ICL due to HZI's alleged poor performance including alleged delay: ICL relied on clauses in the contract that provided grounds for termination based on a failure "to proceed regularly and diligently with the Works" and ICL was removed from site. HZI did not issue a default notice prior to terminating ICL.

ICL claimed that it should have been given, pursuant to the contract, the opportunity to "commence and diligently pursue the rectification of the default within a period of seven (7) Days after receipt of the [default notice]" rather than being terminated immediately.

ICL and HZI disputed whether the default notice was a precondition to termination. The contract's termination clauses included inconsistent wording: Clause "A" stated that in certain circumstances, a default notice would be issued by HZI before termination rights were exercised, but that issuing the default was within HZI's "*absolute discretion."* Clause "B" provided that termination was "*subject to*" the fulfilment of Clause A.

ICL's position was that the wording "*subject to*" in Clause B meant the default notice was a precondition to termination, while HZI's position was that the contractual wording "*absolute discretion*", found in Clause A, meant that whether a default notice was required prior to termination was at HZI's "*absolute discretion*".

Namely, a default notice was not a precondition to termination, but HZI could (in its discretion) choose to issue such a notice.

The Court considered the use of the terms "*subject to*" and "*absolute discretion*" and found that "*subject to*" in Clause B imparted an obligation on HZI to issue a default notice irrespective of HZI's "absolute discretion" in Clause A. Accordingly, a default notice was a precondition to validly terminating the contract. The Court therefore held that it was a condition precedent to HZI having the right to terminate pursuant to the clauses relied upon it for termination that HZI first issue a notice pursuant to Clause A and allow ICL a seven day period to "*commence and diligently pursue the rectification of the default*" that was the subject of the notice.

What does a Default Notice Need to Say?

Recent Australian cases have also considered the requirements for a valid default notice (often referred to as a "show cause" notice under many Australian standard form construction contracts). In the ACT Court of Appeal decision, *R Developments Pty Ltd v Forth* [2017] ACTCA 38, the Court considered whether a builder that had terminated a contract with the owners of a residential construction had done so validly. The builder claimed to have terminated the contract because the owners had failed to supply evidence of their capacity to pay the contract price. The contract contained two terms concerning the owners' obligations that were relevant to the case: (i) an obligation to give evidence to the builder that the owners had obtained finance from a lending authority; and (ii) an obligation that the owners give evidence to the builder of their ability to pay the contract price. Crucially, in its default notice, the builder relied only upon the owners' failure to supply evidence of their capacity to pay the contract sum and did not refer to the contractual clause requiring evidence of the owners' giving evidence of having obtained finance.

The Court held that the builder's termination notice had neither expressly nor impliedly identified the clause requiring evidence of finance and stated that it was "reasonable that the Owners on who a termination notice is served be explicitly informed as to the reason for termination so as to give them adequate opportunity to respond." The case therefore highlights the importance of identifying a clause in the default notice that supports the termination (or contemplated termination). This position, which considers the validity of termination pursuant to the terms of the contract, may be distinguished from common law termination, which may be justified without the identification of a particular contractual clause in a default notice.

If a contract requires it, a party must also give precise details in the default notice as to the time for a response, in order for the other party to have an adequate opportunity to rectify it. In *Westbourne Grammar School v Gemcan Constructions Pty* Ltd [2017] VSC 645, the contract required the default notice to include the date and time by which the builder would have to "*show cause*" (i.e. either provide an explanation of why it was not in breach of contract or take steps to remedy the alleged default). In this dispute, the default notice issued by Westbourne Grammar School merely stated that "*[y]ou must show cause…by the expiration of 7 clear days after this notice is received by you*." The Supreme Court of Victoria found this notice to be inadequate because it failed to specify the date and time for compliance, but rather placed a timeframe around the unspecified time of receipt of the notice by the builder. The Court observed that: "*[t]he notice is of critical importance to both parties*" and that a proper notice "*was designed to put beyond any doubt the time and date by which the builder had to show cause*."

Conclusion

The above cases confirm the importance that a default notice must be issued before termination rights are exercised, if the contract so requires. Furthermore, clauses supporting termination must be referred to in the notice as well as adequate details of the breach, and, if the contract requires it, adequate identification of the time to respond to the notice. This content can be the difference between a valid and an invalid termination. The importance of avoiding a wrongful termination must never be underestimated: a successful action for wrongful termination can result in an award of damages that may include payment of the remainder of money due to the contractor for work performed up to the date of termination and other payments due under the contract. Damages may potentially also include extensive other payments such as payments for loss of profits.

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