



Termination of EPC Contracts

10 things you need to know...

The fall in oil prices from \$100/barrel in July 2014 to a low of around \$50/barrel in January 2015 and approaching \$60 a barrel now has inevitably lead oil companies to re-evaluate the financial viability of their new production projects. A similar but not quite so dramatic fall in the price of natural gas (perhaps for different reasons) has also lead to many producers questioning the viability of their projects.

The price of extracting oil and gas from ever more remote and difficult locations has inevitably lead to an increase in the capital expenditure required to put in place the extraction infrastructure. When energy companies make their final investment decisions, the economics of doing so is typically calculated by reference to future energy prices – necessarily so given the need to be able to demonstrate a return. Whilst fluctuations in future prices are naturally accounted for, a long and significant depression in oil/gas prices is unlikely to have been taken into account.

The quite dramatic changes in market conditions have lead to many energy companies questioning whether or not construction projects (the cost of which have been approved based on a \$80/barrel price) can be sustainable at \$60/

barrel. Where EPC Contracts have already been put in place, what are the options available to purchasers? What are the possible risks and issues Contractors should be alert to?

Whilst the oil/gas industry currently provides a good example of how and when purchasers/clients look at and consider termination rights, a change in market conditions/ environmental conditions for any business in almost any sector can lead to the same considerations – should the client proceed with construction or seek to cut its losses?

In this article we have noted our comments against the FIDIC (Silver Book) which is commonly used on international EPC contracts. Most major and super-major oil companies have their own standard form contracts which will set out bespoke rules for termination. Nonetheless, in English law, the principles set out in FIDIC Silver Book are a good guide for how termination will likely be dealt with under a construction contract – whilst the principles may be similar across most contracts, you should always check the specific wording of your contract (and consult your legal team) before taking any action.



EVERSHEDS

1. Contractor has an obligation and right to complete the works

In all construction contracts, the Employer/Purchaser/Client will always have more extensive termination rights than the Contractor.

This is for good reason; once a construction contract is put in place, a Contractor has both the right and the obligation to deliver the works required. If the Contractor could walk away from that obligation without good reason, that would run contrary to good business sense (causing havoc for a Purchaser's business planning).

However, as the Contractor also has the right to deliver the works and be paid for doing so (often after a long and expensive tendering process), the Contractor also has the right to be paid for completing the works. In other words, the Contractor has a right to the overhead and profit to be earned out of the project – unless there are express words to the contrary in the Contract.

The termination provisions in an EPC contract provide the exceptions to this rule, which generally fall into three main categories:

- The contractor is failing to perform/discharge its duties in some way; or
- The purchaser has elected to cancel the construction contract for some reason of its own (often market conditions, such as those noted above in the oil sector); or
- The purchaser is failing to perform its obligations to the contractor in some fundamental way.

2. The Contract is not “terminated”

It is a common misconception that when there is a termination event the Contract comes to an end.

In fact, if there is a termination of an EPC contract, it is the EPC contractor's employment under the Contract which has come to an end. The obligations to perform all the works ceases but the obligations to perform the works up to the point of termination is not rendered ineffective.

In other words, the EPC contractor will still remain liable for works undertaken prior to termination.

Most EPC contracts will have express words that make this clear and confirm that the Contractor's liabilities continue notwithstanding any termination.





3. Termination for Cause/Default - when can a Purchaser terminate?

The most common form of termination in the construction industry is a termination for default/cause, whereby the Purchaser has determined that the Contractor is fundamentally failing to discharge its obligations to deliver the works. Most EPC contracts will set out a short list of circumstances in which a Purchaser may take this step.

This type of termination is most favourable to a Purchaser and will usually deprive the Contractor of its entitlement to payment for the remainder of the works. As a result, disputes often arise over whether or not a termination of this type was in accordance with the terms of the contract. The consequences of wrongly terminating an EPC contract can be significant and lead to claims in damages from contractors.

A termination for default will always require a substantive factual case to support the grounds for termination – it is not enough to simply point to a ground of termination, the Purchaser should be able to identify evidence which supports its decision. This is not the type of termination which typically arises due to a change in market conditions

– it is not supposed to be used as a way to cancel a project a client no longer wants. Nonetheless, some clients will try to identify a case for termination for default in order to secure a more favourable financial settlement than would arise with other options.

FIDIC Silver Book, Clause 15, details the 6 circumstances in which a Purchaser may terminate the Contract for contractor default. These are set out at clause 15.2 and include a failure to comply with a Notice to Correct (clause 15.2(a)); abandoning the Works or otherwise plainly demonstrating an intention not to perform the Contractor's obligations under the Contract (15.2(b)); insolvency (15.2(e)); and subcontracting the whole of the Works or assigning the Contract without obtaining the required consent (15.2(d)).

Separate to the provisions of clause 15.2, the Contract also provides for termination by the Purchaser pursuant to clauses 9.4(b) (failure to pass tests on completion); 11.4(c) (failure to remedy defects); 19.6 (optional termination payment and release); and 19.7 (release from performance under the law).

4. What is the procedure for termination?

Where a Purchaser is satisfied that it can show that the Contractor's default satisfies one or more of the criteria specified in the Contract, the Contract will prescribe the procedure to be followed. Typically this will entail:

- Purchaser issuing a termination notice;
- Contractor having time to remedy the default (not always applicable) – which may assist the contractor in avoiding a termination taking place;
- A period of time allowing the contractor to leave site (assuming the termination proceeds);
- Specific rules applying in how the contractor leaves site and the financial rules that apply thereafter.

In FIDIC Silver Book, clause 15.2 details the procedure to be followed in the event of termination. In all circumstances, the Purchaser may terminate the Contract on giving 14 days' notice to the Contractor and remove him from the Site. There is no opportunity for the Contractor to remedy his default before termination is effective.

All notices must be in writing and delivered by hand (against receipt) or sent by mail, courier or by email if specified in the contract. The notice must be sent to the Contractor's address as specified in the Contract, unless either the Contractor gives notice of another address or sends a request for approval or consent from a new address. The notice provisions in each contract will vary and on issues as important as termination, the contractual procedures must be followed precisely in accordance with their terms (no matter how onerous).

In the case of a termination for insolvency (15.2(e)) or bribery/corruption (15.2(f)), there is no requirement to give 14 days' notice; the Purchaser may terminate the Contract with immediate effect.

Thereafter, the Contractor must leave Site and deliver any required Goods (which includes Contractor's Equipment - all apparatus, machinery, vehicles and other things required for the execution and completion of the Works), all Contractor's Documents and other design documents to the Purchaser. These can then be used by the Purchaser to complete the Works, the cost of which can be claimed from the Contractor under clause 15.4(c)).

The Purchaser is also entitled to sell the Contractor's Equipment and Temporary Works to discharge any debts owed by the Contractor. However, this can cause difficulties where there is uncertainty over ownership of certain assets, potentially giving rise to a claim against the Purchaser for conversion in circumstances where the Contractor is not in fact the legal owner.



5. What happens after termination?

EPC contracts will prescribe a set of rules as to how and when the Contractor's account will be valued after a termination for cause. Whilst the Contractor will be entitled to be paid for works undertaken, the Purchaser will usually have the right to make deductions against the Contractor's account which arise out of the termination. This can seem draconian for an EPC contractor, particularly if the basis for termination is disputed.

Some EPC contracts will considerably delay the release of any monies (including retentions/bonds) or oblige the Purchaser to undertake a valuation of the Contractor's works for quite some time after the termination.

In FIDIC, Clauses 15.3 (valuation at date of termination) and 15.4 (payment after termination) deal with the consequences of a termination by the Purchaser. Clause 15.3 provides that as soon as practicable after notice of termination has taken effect, the Purchaser must either agree or determine the value of the Works, the Goods and the Contractor's Documents, together with any other sums that fall to the Contractor in respect of works carried out in accordance with the Contract.

If the Purchaser considers that he is entitled to any payment under the Contract he may pursue a claim in accordance with clause 2.5 (Purchaser's claims); with-hold further payments to the Contractor until any/all costs incurred by the Purchaser have been established; and/or recover from the Contractor any losses and damages incurred by the Purchaser and any additional costs incurred as a result of completing the Works (after allowing for any sums due to the Contractor in accordance with clause 15.3). In the case

of the latter, after recovering its losses, damages and/or extra costs, any balance must be paid to the Contractor.

These are the principle reasons why it is always more favourable for a Purchaser to terminate a contract for cause - the rules are overwhelmingly in the Purchaser's favour, the financial settlement is in the Purchaser's control and the financial entitlement of the Contractor after taking into account the deductions a Purchaser may make can be considerably less than the value of works undertaken.

6. Have a Plan

Given the timescales in which termination can take place (under FIDIC it can be as little as 14 days from notice to exit), Purchasers should ensure they have a plan for what happens after termination.

Assuming the Project needs completion, bringing in a new EPC contractor to complete partially completed works will always be difficult and the Purchaser should consider issues such as:

- Mobilisation periods;
- Tender obligations (market competition);
- Design liability (for example, will an incoming EPC contractor adopt another's design and if so, at what cost?);
- Programme and liability for delay;
- Balance of risk (an incoming contractor will be in a very strong negotiating position; and
- Is there a risk of a claim from a contractor for wrongful termination?





7. Can a Purchaser terminate in circumstances where there is no Contractor default?

There are reasons other than the default of the Contractor that persuade a Purchaser to terminate an EPC contract, such as the market conditions currently seen in the oil/gas industry. Most EPC contracts provide that a Purchaser may terminate a contract “at will” or “for convenience”.

In these circumstances, a Purchaser does not need to establish any entitlement to terminate. This is a simple election by the Purchaser which may mean that it no longer wishes to complete the project because it is no longer commercially viable, it may be “mothballing” the project until there are better market conditions or it may be seeking to appoint another contractor to undertake the works for its own reasons (subject to the form of contract being used). The key point to note is that the Purchaser does not need to explain or justify its reasons for its actions, provided it complies with the terms of the contract.

However, this right does not come without its cost. The cost payable to a contractor on termination at convenience will vary from contract to contract – ranging from paying unpaid overhead and profit on the remainder of the works to costs properly incurred in anticipation of completing the works and demobilisation costs.

In FIDIC, Clause 15.5 provides for a Purchaser’s termination for convenience at any time and without any default by the Contractor. Termination will take effect 28 days after the later of receipt by the Contractor of the Purchaser’s notice to terminate or return of the Performance Security by Purchaser.

Under FIDIC rules, there is no allowance for profit and a Purchaser is not permitted to terminate for convenience simply because he wishes to carry out the Works himself or arrange for another contractor to do so at a lesser cost. As such, the Contractor would be entitled to recover the value of work done as at the date of termination and any other cost or liability reasonably incurred in the expectation of completing the Works. The Contractor would also be entitled to recover the cost of clearing the Site. No other compensation would be payable.

8. What if there is a good faith provision in the Contract?

When a termination at convenience takes place, it is often argued that the Purchaser will have breached any obligation to act in good faith which may also be found in the Contract. How can a Purchaser be acting in good faith towards a Contractor if it chooses to bring the contract to an end for its own reasons (and thereby deprive the Contractor of the overhead and profit it would have earned on the project)?

There have been a number of recent cases in the English Courts that have addressed good faith obligations. Our article on how good faith obligations should be interpreted sets out a full analysis of what the current position is in English law.

A termination at convenience clause which includes a limitation on when the right can be exercised already provides a limitation on the right (such as under FIDIC a Purchaser is not able to use the clause if it intends to appoint an alternate contractor for the same works). However, a generic good faith obligation elsewhere in the contract not linked to the termination provisions is very unlikely to prevent the Purchaser exercising his right to terminate for convenience. The cases of *Mid-Essex Hospital Services NHS Trust v Compass Group UK Limited* and *TSG v South Anglia* have established that English law is not likely to favour any such arguments. *TSG v South Anglia* related to an express term permitting termination at will. In this case there was no suggestion that work had been performed badly and in fact the employer gave no reason for requiring termination. There was a clause in the ACA Standard Form of Contract for Term Partnering (TPC 2008) providing that the parties should work together individually in a spirit of trust, fairness and mutual co-operation for the benefit of the Term Programme. The English Courts held that this clause did not fetter the employer’s right to terminate for convenience. The “trust” clause was primarily concerned with the assumption, deployment and performance of roles, expertise and responsibilities set out in the Partnering Documents. Therefore, termination for convenience was permitted without any limitation on the employer’s powers. Unlike Clause 15.5 of FIDIC, such termination was permissible in order to give the work to another contractor.

Implied duties of good faith have also been considered in the English case of *Yam Seng*. Again, this implied duty (which only arose in special circumstances) is very unlikely to fetter any right to terminate at convenience.

9. What is the effect on sub-contractors?

All good EPC contracts will provide that once a main contractor's contract has been terminated by the Purchaser, all the sub-contracts will automatically also be terminated.

However, Contractor's should ensure that they comply with the relevant rules in the contracts on this issue – notice may be required and confirmation as to what steps the sub-contractors are required to take.

Contractors will also have to follow agreed procedures regarding sub-contractor's financial accounts in accordance with the terms of the Contract.

10. Can a Contractor terminate the Contract?

A Contractor may terminate a Contract assuming the Contract provides that it can do so.

As is the case for any Purchaser termination, the rules and procedures which the Contractor must follow are set out in the terms of the Contract.

For example, in FIDIC the Contractor may terminate pursuant to clause 16.2. The circumstances in which a Contractor may be entitled to terminate are similar to those in which the Purchaser can terminate and include where the Purchaser

substantially fails to perform his obligations under the Contract (clause 16.2(c)); a period of prolonged suspension which affects the whole of the Works (16.2(e)); and if the Purchaser becomes bankrupt or insolvent (16.2(f)).

In the event that one of the 6 grounds for termination can be established, the Contractor may terminate the Contract by giving 14 days' notice to the Purchaser. As in the case of an Purchaser's termination, the 14 day notice period is not required in the case of insolvency, nor is it required in the event of a termination under clause 16.2(e).

Following a Contractor's termination, the Contractor ceases all further works except for those instructed by the Purchaser that are safety critical. The Contractor is also required to hand over to the Purchaser the Contractor's Documents, Plant, Materials and other work for which he has received payment and remove all other Goods from the Site (except those necessary for safety) and leave the Site.

Once notice of termination by the Contractor has taken effect, the Purchaser is required to:

- return the Performance Security;
- pay the Contractor in accordance with clause 19.6 (optional termination, payment and release); and
- pay to the Contractor the amount of any loss of profit or other loss or damage sustained by the Contractor as a result of the termination.



A note of Caution: Final Thoughts

It is important to note that termination is a severe step to take by either party to an EPC contract.

Challenging market conditions may exist but both parties will need to consider their positions very closely if termination occurs. Termination is very rarely not contentious and frequently results in significant disputes given the consequences for contractors.

Wrongful termination can give rise to substantial claims for damages and therefore you should always carefully consider the Contract and take legal advice before terminating the contract.

However, termination is on the rise in certain industries given the challenging market conditions and questionable commercial viability of once sound projects.

The rules and procedures relating to termination need to be carefully considered both when drafting the Contract and when considering taking action to terminate.

This note does not address repudiatory breach or termination at law – for which different rules apply.

Keep in touch



Visit our website for latest news and events from Eversheds

www.eversheds.com/global/en/what/services/construction-and-engineering/index.page



www.eversheds.com

©EVERSHEDS LLP 2015. Eversheds LLP is a limited liability partnership.
DT04699_05/15

Authors



Paul Giles
Partner

0845 497 8680
paulgiles@eversheds.com



Clare Rushton
Associate

0845 497 8686
clarerushton@eversheds.com

For further information please contact:



Simon Oats
Global Head of Construction
and Engineering

+44 207 919 4750
simonoats@eversheds.com