



# QUANTIFYING THE FINANCIAL EFFECTS OF TERMINATION

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## PRACTICAL CONSIDERATIONS

Most standard form construction contracts contain provisions under which the employer can terminate the contractor's employment for default. Default of the contractor can arise for several reasons. The events that entitle the employer to terminate should be clearly set out within the contract.

Notwithstanding the reasons for termination, quantifying the financial effects and the monies due to, or from, a party can be problematic, which may lead to disputes and the expenditure of additional monies to expedite recovery.<sup>1</sup>

The purpose of this article is to identify some of the basic principles to consider when quantifying the effects of termination, either as the engineer, the parties to a contract or as a third party (collectively hereinafter referred to as the "Assessor"). Reference is made to the termination provisions of the FIDIC Red Book 2017 ("Red Book")<sup>2</sup>, however this article intends to identify principles that can be adopted generally.

### TERMINATION FOR CONTRACTOR DEFAULT [SUB-CLAUSE 15.2]

Following termination of the contractor's employment for default, the employer has a contractual remedy to complete the works and/ or arrange others to do so. The employer may use any goods (which may include the contractor's equipment, materials,

plant and temporary works) and the contractor's documents to complete the works. The contractor is required to comply with any reasonable instruction from the employer, for the assignment of any subcontract; and for the protection of life or property, for the safety of the works. Any employer supplied materials and/or equipment should be made available to the employer, if provided to the contractor.

The employer may suspend payment until any additional costs, losses or damages that flow from the termination, are ascertained.

### VALUATION AFTER TERMINATION [SUB-CLAUSE 15.3]

It is of utmost importance that a valuation of the works is carried out at the date of termination ("DOT"). The valuation shall form the basis of calculating any monies owed to, or from, the contractor and will inevitably form the basis of determining the balance scope of works to be completed.

Sub-Clause 15.3 *prima facie* appears to be self-explanatory in this respect, however in practical terms it raises a few commercial considerations for the Assessor:

*"the Engineer under Sub-Clause 3.7...shall proceed to agree or determine the value of the Permanent Works, Goods and Contractor's Documents and other sums due to the Contractor for work executed in accordance with the Contract..."*

Sub-Clause 3.7 encourages the parties to consult in order to agree the valuation. As part of the consultation process, the parties may jointly or independently employ the expertise of quantity surveyors<sup>3</sup> to undertake or assist in preparing the valuation. If the parties are unable to agree the valuation, the engineer must issue a determination within the prescribed time limits.

### Undertaking the Valuation

It is important to recognise that the valuation is to be a gross valuation in accordance with the terms of the contract. The valuation may be calculated as the aggregate of items 'a)' to 'c)' below, less the actual monies paid to the contractor, including a provision for any outstanding monies to be recovered for advance payments as follows:

- a. *Permanent Works and Variations;*
- b. *plus, Materials/Plant on site or delivered to the engineer;*
- c. *plus, Claims; and*
- d. *less, monies paid to the contractor and any balance of advance payment(s) owing to the employer.*

The process of preparing a valuation of the *Permanent Works and Variations*, should be one based on factual evidence, as far

<sup>1</sup>Through a formal dispute resolution process.

<sup>2</sup>FIDIC Red Book 2017, assuming that termination is lawful and the Contract survives termination.

<sup>3</sup>Or any other type of surveyor / consultant that may assist in agreeing the as-built status of the works.

as reasonably possible. It is essential that the Assessor and/or the parties visit the site as soon as the termination becomes effective, in order to sufficiently record the as-built status of the works.<sup>4</sup> Valuation can be more difficult under lump sum contracts, typically when elements of the works are partially complete and the contract does not include a mechanism for valuation, for example, the absence of a schedule of rates or a bill of quantities.<sup>5</sup> Some standard form contracts contain provisions which allow for a valuation to be based on a reasonable amount.

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Consideration may need to be given to the valuation of *Permanent Works* that are considered defective. The Red Book states that the valuation ‘shall not include the value of any *Permanent Works* to the extent that they do not comply with the Contract.’<sup>6</sup> In practice however, if it is the employer’s intention to suspend payment to the contractor until any additional costs are ascertained, it may be practical to include the full value of the *Permanent Works* and set-off any costs for remedying defects once established.<sup>7</sup>

The valuation of *Preliminaries* may be more subjective. Consideration should be given to the valuation of fixed lump sum items.<sup>8</sup> For example, it may be that the contract price includes a lump sum for design. The Assessor may need to review the scope of the contractor’s design and make a valuation, taking into consideration the progress of the design and the production of deliverables at the DOT. A simple pro-rata of the allowance(s) contained within the contract price may not generate an accurate valuation. Further consideration may also need to be given in instances where the contractor has caused critical delay to the project. It may be necessary to abate the valuation of preliminaries to reflect the same period of delay caused by the contractor.

The valuation should also recognise the value of any *Materials and/or Plant* intended to form part of the works, either on or off site. There are several legal issues to consider in this context such as ownership, possession and retention of title. The first

step is always to check the terms of the contract. Most contracts provide that title passes when (i) they are delivered to site; or (ii) when the value of goods have been included within an interim payment. Under the provisions of the Red Book, the contractor must deliver to the engineer, any materials and/or plant required by the employer at the DOT. These may be goods ordered, but not yet delivered to the site. It may require a reasonable period to pass to allow for such items to be delivered to the engineer. Nevertheless, the valuation should include all the items in the possession of the engineer and on site. The contract may identify the value for each item, in the absence of this, it is unclear how the Assessor is to value the goods. One approach may be to value the goods on a cost-plus basis, inclusive of all reasonably incurred costs such as mobilisation. The contractor should present satisfactory records for such goods, including purchase orders, receipts, proof of shipping costs etc.<sup>9</sup>

The value of all *Claims* determined by the engineer up to the DOT, should also be included within the gross valuation.

Deducted from the gross valuation should be the monies already paid to the contractor and the amount, if any, not yet recovered from any advance payment made by the employer to the contractor. The calculation will determine the amount owed to or from the contractor under Sub-Clause 15.3.

#### **PAYMENT AFTER TERMINATION [SUB-CLAUSE 15.4]**

The employer may withhold the payment of any monies owed to the contractor as agreed or determined under Sub-Clause 15.3, until all the costs, losses or damages, associated with the completion of the works have been established. The employer may be entitled to set-off the following from the monies owed to the contractor:

1. Additional costs of executing the works;
2. Other costs reasonably incurred including the employer’s losses and/or damages; and
3. Delay damages.

#### **Additional Costs of Executing the Works**

After termination of the contractor (“Contractor A”), the employer may choose to appoint a replacement contractor (“Contractor B”), to complete the works. Ideally, the tender for the completion works should be competitive, inclusive of free issue material and/or plant left on site or in the possession of the engineer at the DOT. Provisions may also be made for the use of Contractor A’s equipment and/or temporary works if retained by the employer.

It is important to remember that the employer is only entitled to

recover the extra over costs of completing the works. When re-tendering the completion works, it is highly unlikely that the final scope of the works can be determined, and inevitably there may be further variations to be issued up to completion. To calculate the extra over costs, it is important that the Assessor recognises that the final account for Contractor A is still ongoing and should be compared to the final account of Contractor B for the same works at completion. For example, under the terms of the Red Book, the contract price may be subject to adjustments, including changes to items and/or quantities.<sup>10</sup> The Assessor should prepare a final account for both contractor’s up to the completion of the works, referred to by the RICS as a notional final account.<sup>11</sup> Any additional costs incurred as a result of completing the works with Contractor B can be set-off from any monies due to Contractor A under Sub-Clause 15.3.

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### **The employer may withhold the payment of any monies owed to the contractor as agreed or determined under Sub-Clause 15.3, until all the costs, losses or damages, associated with the completion of the works have been established.**

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Difficulties may arise when valuing variations for works that are dissimilar to the works contained within Contractor A’s contract. In such instances, it may be reasonable to value the varied works taking into account all of the information contained within Contractor A’s contract, as far as reasonably possible, for example, labour constants, labour rates, rates for overheads and profit etc. and apply that information to current market rates and prices for the varied works.

#### **All other costs reasonably incurred and the employer’s losses and damages**

Most certainly the employer will incur further costs, losses and damages in connection with the completion of the works. A general list of items that the employer may be entitled to set-off from Contractor A are set out below:

1. The cost of making good defects to Contractor A’s works  
– The completion contract should distinguish between the completion works and making good of defects. If the full

<sup>4</sup> Records may include; photographic / video evidence, witness statements, marked up drawings, surveys and the like.

<sup>5</sup> The parties are encouraged to give due consideration to similar matters at contract formation.

<sup>6</sup> FIDIC Red Book, Clause 15.3, Valuation after Termination for Contractor’s Default.

<sup>7</sup> Set-off made in accordance with Sub-Clause 15.4

<sup>8</sup> Fixed priced preliminaries are items which are independent of duration.

<sup>9</sup> Sub-Clause 14.5, Plant and Materials intended for the Works.

<sup>10</sup> FIDIC Red Book 2017, Sub-Clause 14.1, Contract Price.

<sup>11</sup> For further guidance, refer to the RICS Professional Guidance, UK ‘Termination of Contract, Corporate Recovery and Insolvency’.

value of the defects is to be claimed in the employer's set-off, then the valuation for Contractor A at termination must include the full value of the same items of work, as if they were in accordance with the contract.

2. Interim costs such as making the site safe, additional insurances, the employment of security and the removal of redundant items.
3. Costs of procuring the completion works, quantity surveyor's fees, additional in-house resource, surveys and the employment of other third parties.
4. Any legal fees incurred as a result of termination, for example the drawing up of new contracts for the completion works and the assignment and novation of materials suppliers and sub-contractors etc.

This list is not exhaustive and depends on the relevant contract in use and the applicable law. Items available in one jurisdiction may be considered too remote in other jurisdictions. There are also items which may be caught by the term consequential losses, and a contract may exclude recovery of such items,<sup>12</sup> these may include loss of profit, loss of rent, interest/financial charges etc.

#### **Delay Damages**

The employer may be entitled to set-off delay damages related to the late completion of the works. The basis on which the damages are calculated will depend upon the wording of the contract.<sup>13</sup>

One issue to be considered is whether a delay damages clause can be applied up to and beyond the DOT. The issue was recently considered by the Court of Appeal in *Triple Point Technology Inc ('TPT') v PTT Public Company Ltd ('PTT') [2019] EWCA civ 230*. In this case, TPT was liable to pay delay damages 'up to the date PTT accepts such work'. The project had 3 milestones; stages 1 and 2 were successfully handed over by TPT, however PTT terminated the contract prior to the completion of stage 3. At this point in time the project was in delay.

One of the issues raised in court was whether PTT was entitled to rely upon the delay damages clause, and, if so, whether the delay damages accrued up to the DOT, or beyond. It was found that PTT was entitled to rely upon the clause, calculated up to the date of completion for stages 1 and 2.

However, for stage 3 the clause was found to be inapplicable. The contract stated that delay damages were to be applied 'up to the date PTT accepts such work', and therefore the clause could only apply to complete stages of work at the DOT. For incomplete works, PTT was entitled to recover damages at large, up to the date that the works were complete, subject to the necessary burden of proof.

Although the Courts stressed that the outcome in each case would depend on the exact wording used, it also doubted recent cases which have held that pre-determined delay damages continue post-termination, until the works are completed by the employer or the replacement contractor.<sup>14</sup>

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### **The employer may only set-off additional costs, losses or damages, reasonably incurred as a result of the termination.**

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#### **Reasonableness of additional costs, losses and damages**

The employer may only set-off additional costs, losses or damages, reasonably incurred as a result of the termination. Whether costs incurred are reasonable involves detailed enquiries such as whether the procurement process was appropriate for the works procured, or whether the contract terms were reasonable.

Disputes can arise in relation to the reasonableness of the rates and prices procured for Contractor B, which are often more than Contractor A's. It is important to consider a few issues in this respect.

It's not necessarily correct to compare the tender for the original works with the tender for the completion works because, for example, Contractor A may have underestimated the project. Further, a reasonable price at any point in time will, to a large extent, be dictated by market forces, and, given that the tender for the completion works will inevitably be carried out later than the original works, varied market conditions may prevail. Issues may also arise if the employer procures Contractor B and its tender is not the most competitive. Whether a price is reasonable

is a different consideration from whether a price is the lowest price possible. It is important to keep in mind that a reasonable price requires to be appropriate and fair in the circumstances. A price that is so low, that it is insufficient to carry out the works to the required quality and within the required timescales, may not be a reasonable price. Other factors such as the inefficient nature of the works, or the complexities which arise in completing works commenced by another party, should also be considered.

#### **SUMMARY**

This article sets out a small sample of the issues which may need to be considered when quantifying the financial effects of termination. Parties are encouraged to be mindful of the termination provisions contained within their contracts. Quite often, parties fail to recognise the termination provisions, and therefore, incorrectly value any further payment in accordance with the terms of the contractual payment mechanism. These terms tend to differ somewhat to the party's entitlements under the termination provisions.

<sup>12</sup> FIDIC Red Book 2017 addresses consequential losses at Sub-Clause 1.15, Limitation of Liability. Such clauses are also commonly referred to as 'Consequential loss exclusion clauses.'

<sup>13</sup> *Triple Point Technology, Inc v PTT Public Company Ltd [2019] EWCA Civ 230*.

<sup>14</sup> Hogan Lovells, Talking Point: Construction and Engineering, May 2019, 'Where work is never completed, delay liquidated damages may not accrue up to termination.'



## About the author

**Michael Berrigan** is an Associate Director working in HKA's Expert Services team in Dubai, UAE. He is a Quantity Surveyor with 17 years' experience working initially for main contractors in the UK and for the past 6 years working in the dispute resolution sector in the Middle East, Africa and Asia.

Michael has been involved in the preparation of claims and has assisted quantum experts in the preparation of expert reports for matters in dispute adjudication boards and arbitration. Michael has worked on a wide range of international projects including high-rise buildings, infrastructure works, airports, power stations and oil and gas facilities.

Michael holds a BSc in Quantity Surveying and Commercial Management from Bolton University, UK and an LLM in Construction Law and Dispute Resolution from Salford University, UK.

Michael is a Fellow of the Chartered Institute of Arbitrators (FCIArb), a member of the Chartered Institute of Building (MCIQB), an Associate Member of the Academy of Experts (AMAE) and an Associate Member of the Royal Institution of Chartered Surveyors (ARICS).

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