

## Construction - Switzerland

### Failure of performance tests and contractual grounds for termination

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### Background

Many of the international arbitrations that take place in Switzerland are related to construction and engineering contracts and to contracts for the supply of equipment to industrial plants or construction projects. The awards rendered in these arbitrations are confidential, but some of the facts and reasoning of the arbitral tribunal are made public if a party seeks to set aside an award before the Federal Supreme Court, which has exclusive jurisdiction to annul or confirm international awards. On June 9 2009 the court upheld an award that dealt with the relationship between statutory and contractual grounds for termination of a works contract where the failure of performance tests was alleged. Based on the summary provided in the court's judgment, this update examines the facts of the case and the tribunal's reasoning, and considers the court's reasoning in upholding the award.

### Facts

The dispute arose from a Hungarian steel plant's purchase of a loading system from a Swiss supplier to modernize its production facilities. Pursuant to the supply agreement concluded by the parties, the purchase price was to be paid in two advance payments and 37 monthly instalments, payment of which was to begin upon the plant owner's formal acceptance of the system. The supplier installed the system in the plant, but an initial attempt to start the system was unsuccessful. The outcomes of two subsequent attempts were disputed. The plant owner considered that the system had never functioned properly because of design flaws. The owner therefore terminated the supply agreement, requested the reimbursement of the instalments that had already been paid and asked the supplier to remove the system, which it had already dismantled, from its plant. In response, the supplier commenced an International Chamber of Commerce arbitration in Switzerland pursuant to the supply agreement, seeking payment of the outstanding instalments of the purchase price. The owner raised a counterclaim for reimbursement of the instalments already paid and damages resulting from the termination of the contract.

### Arbitral award

In its award of January 29 2009 the arbitral tribunal ordered the owner to pay the supplier €1.9 million, plus the remaining instalments as they became due, and dismissed the owner's counterclaim. The tribunal found that the owner's termination had not complied with the terms of the supply agreement. Article 32(1) of the agreement allowed the parties to terminate the agreement on only two grounds: the insolvency of a party or the existence of a material breach that was not cured in a timely manner after written notification. A failure to achieve contractually agreed performance guarantees would have qualified as a material breach, but Article 32(7) required the owner to conduct discussions with the supplier regarding possible compensation in excess of the contractually stipulated penalties before terminating the agreement for material breach. Furthermore, the tribunal found that in order to determine whether the performance guarantees had been met, the results of the final performance test required by the supply agreement had to be taken into consideration. However, the parties had not carried out this final performance test, the failure of which was a prerequisite for termination. As a result, the tribunal ruled that the owner was not entitled to terminate the contract, as no material breach had occurred within the terms of the agreement.

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The Code of Obligations provides for different and additional grounds for termination, which were also invoked by the owner. However, the tribunal found that the parties had excluded the code's provisions on termination by agreeing to an exhaustive list of grounds for termination.

The tribunal nevertheless added that even if the code's termination regime had applied in addition to or instead of the contractually agreed provisions, the owner's termination would not have been lawful. The owner would not have been entitled to invoke delay as a ground for termination pursuant to Article 366(1) of the code, as the supplier had complied with the contractual delivery dates. The owner was also estopped from terminating the supply agreement pursuant to Articles 107 and 366(2) on the grounds that the system was defective, as it had not immediately notified the supplier of such termination. Moreover, the instalments owed to the supplier became due pursuant to the supply agreement only after formal acceptance of the system by the owner, and the successful performance tests were a prerequisite for such acceptance. The tribunal found that the owner had deprived the supplier of the opportunity to conduct the tests by terminating the contract. Therefore, the owner was deemed formally to have accepted the system as of the day of the unlawful termination.

### **Supreme Court judgment**

The owner challenged the award before the court on the grounds that it breached the parties' right to be heard under Article 190(2)(d) of the Private International Law Act, as the tribunal had allegedly applied contractual and legal provisions in a manner that the parties had not expected. The parties' right to be heard prohibits a tribunal from relying in its award on contractual or legal provisions that have not been pleaded by the parties. However, the court found no violation of the right to be heard. One of the contractual provisions in question had been mentioned by the supplier in its pleadings, at least in an alternative defence. Another provision, Article 32(7) of the agreement, had not been explicitly relied upon by the supplier, but the court held that the parties should have expected that the arbitrators would consider all the provisions of the contract that were relevant to the parties' termination rights.

The owner also asserted that the tribunal had not properly warned the parties of its view that Articles 107 and 366(2) of the code required immediate notification of termination for defects. The court confirmed that the owner's remedies for delays or defects were not limited to those set out in Article 366, which essentially provides for repair by a third party at the supplier's or contractor's cost. The owner could also terminate the contract for defective performance pursuant to Article 107. However, such termination required advance notice by the owner and a reasonable grace period for the supplier to repair the defect. The grace period is not mandatory if it is clear that the supplier or contractor will not seek to repair the defect, but in such cases the owner must terminate the contract immediately. The court concluded that the arbitral tribunal had merely applied the statutory provisions on which the owner itself had sought to rely. Therefore, the owner could not claim to have been surprised by the arbitral tribunal's application of Articles 107 and 366.

### **Comment**

The Supreme Court does not review the substance of arbitral awards. In essence, its analysis is limited to due process violations and jurisdictional objections. However, some conclusions on the termination of works contracts can be drawn from its findings, particularly from its summary of the tribunal's reasoning, although it should be noted that the award was not reproduced in full in the judgment, but merely summarized.

The code's provisions on parties' rights to terminate a works contract are not mandatory and can therefore be modified by contract or replaced entirely. Whether the parties meant to replace the statutory provisions or merely amend or complement them is a matter of contractual interpretation.

Irrespective of whether contractual or statutory provisions apply, a party that wishes to terminate the contract must comply with all relevant notice requirements. The code provides for such requirements, but they are not mandatory; therefore parties can, and often do, agree on tailor-made solutions.

A works contract can also provide for a special regime governing the acceptance of the works. However, the owner must give the contractor an opportunity to perform any test that is a prerequisite for acceptance. Even if actual acceptance did not occur as stipulated in the contract, the works may be deemed to have been accepted if the owner prevented the contractor from performing such tests.

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