Is Cheaper Better? Using the Termination for Convenience Clause to Replace a Contractor

M. Saleh Jaberi*

Construction contracts; Contract terms; Contractors; Freedom of contract; Good faith; Performance; Termination

Abstract

The termination for convenience (TFC) clause was initially used by the US government to create flexibility in contracts and preserve public resources but was later extended to other contracts and used for other purposes, including replacing one contractor with a cheaper one. Common law courts, however, resorted to a few legal principles, such as the duty of good faith to limit the power of employers in exercising the TFC clause to engage another contractor. In this article, the application of various types of TFC clauses to replace a contractor and its limitations are analysed and the confrontation of the express TFC clause and the duty of good faith is discussed.

1. Introduction

The fundamental principle of "binding force of contract" is that neither party can easily revoke a contract and deprive the other party of the rights they expect to receive from the contract. At the same time, the principle of "freedom of contract" allows the parties to define the scope of their obligations, which will then be given effect by the law.[1] By aligning the two principles, the common law recognises both parties' choices to incorporate the express right of termination in their binding contract for one or both of them, which may be the termination for cause or termination at the will of the party upon whom the right is conferred, which is known as termination for convenience (TFC). Regarding the history of termination for convenience, it is said that this "clause dates to the mid-1900s, when at a time of newfound peace the U.S. government needed a mechanism by which to quickly extricate itself from the extensive contractual obligations into which it had entered during wartime".[2] Today, however, the TFC provision is widely used in commercial

* Dr M. Saleh Jaberi is an attorney at law and a partner at ESK Law Firm. He is also the author of the book *Construction Law* and is actively involved in construction contracts. Email: jaberi@esklawfirm.com.

[1] *Photo Production Ltd v Securicor Transport Ltd* [1980] UKHL 2 HL per lord Diplock: "A basic principle of the common law of contract … is that parties to a contract are free to determine for themselves what primary obligations they will accept". See also: *Eurico SpA v Philipp Brothers* [1987] 2 Lloyd's Rep. 215 CA (Civ Div) at 218; *Homburg Houtimport BV v Agrosin Private Ltd (The Starsin)* [2003] UKHL 12, [2003] 3 W.L.R. 711 at [57]; *Prime Sight Ltd v Lavarello* [2013] UKPC 22; [2014] A.C. 436.

[2] Michael C. Loulakis and Lauren P. McLaughlin, "Court Reviews Allowable Costs in Termination for Convenience Dispute" (2007) 77(1) *Civil Engineering Magazine* 96. It is believed that the basis of modern termination for convenience clause first created in *United States v Corliss Steam-Engine Co*, 91 US 321, 23 L.Ed. 397 (1876). See

contracts and is increasingly appearing in construction agreements. The protection of public interests, economic instability and ongoing uncertainty regarding the regulatory environment in the medium to long term have been the major reasons for which employers use the TFC clause in contracts.

Considering the principle of freedom of contract, common law court was reluctant to interfere with the intentions of parties that led to the termination of contracts; no challenge was raised regarding whether the termination provision is reasonable or whether it is reasonable for a party to enforce it.[3] However, it is believed that the principle of freedom of contract was everywhere in retreat during the 20th century due to inequality in the bargaining powers of contracting parties and the undue influence of this principle on consumers' true interests.[4] Therefore, courts and governments have tried to curb the principle through statutory regulations or equitable rules such as good faith and fair dealing so that contracts can reflect the reality of today's business conditions.

Termination for convenience represents the highest level of contractual freedom, as it allows the powerful party to withdraw from the contract at any time without any reason, even if it damages the commercial stability of the counterparty. Nevertheless, common law courts demonstrate that the TFC clause does not give employers an unlimited ability to abuse their discretion; as such, the application of this clause is subject to certain limitations. One example of an owner's justification for using the TFC clause is being offered a cheaper deal to finish construction work; the clause enables them to remove the contractor from an entire construction project or parts of it. If the employer is a state organisation, preserving the public budget is another reason that may be presented to justify changing a contractor to get a better price for the remaining work. The main purpose of this article is to examine the use of the TFC clause and whether this clause allows employers and owners to engage a new contractor after a contract has already been awarded to a different contractor. This study also explores different opinions regarding the conflict between the TFC clause and the duty of good faith and considers an approach that can be followed to avoid the unexpected interpretation of the clause.

2. Right of the contractor to complete work

From the time a contractor decides to conclude a construction contract, either through direct negotiation or through a tender procedure, they consider various goals, one of the most important of which is to perform all the work requested by the owner and receive the entire contract price. In some construction projects, only part of the work is profitable for the contractor, so that part represents the contractor's main motivation for fulfilling the contract, and removing this part of the work causes damage to the contractor's entire contractual purposes. In addition, premature termination or removal of part of the work causes damage to the contractor's financial circulation, which may have a negative impact on their other contracts. Therefore, it has been said that performing all the work mentioned in

Torncello v United States, 681 F.2d 756 (Fed. Cir. 1982); *Linan-Faye Const. Co v Housing Authority of Camden*, 49 F.3d 915 (3d Cir. 1995).

[3] Hugh Beale, *Chitty on Contracts*, 32nd edn (London: Sweet & Maxwell, 2017), para.22-048.

[4] F.H. Buckley, *The Fall and Rise of Freedom of Contract* (Duke University Press, 1999), p.1.

the contract is not only a duty of the contractor but also their right. The leading case that corroborates this argument is *Abbey Developments Ltd v PP Brickwork Ltd*.[5]

Abbey was a house-building contractor, and PP Brickwork was a labour-only brickwork subcontractor. The contract stated that whilst there were 69 plots on the site of the housing estate that was being built, Abbey reserved the right to vary the number of plots that PP Brickwork would work on. The variations clause in the contract gave Abbey extensive power to reduce or increase the quantity of work offered to the subcontractor or to suspend the subcontractor's work. Abbey was dissatisfied with the subcontractor's performance and made a number of written complaints. Claiming the subcontractor's failures, Abbey stated that it would limit PP Brickwork's work to the plots on which it was currently working, and once those plots had been finished, its contract would be determined. Abbey also said that an alternative contractor would be employed to complete the development and asked the court for a declaration that it was entitled to do so. HHJ Humphrey Lloyd QC stated:

> "The justification for these decisions is in my judgment to be found in fundamental principles. A contract for the execution of work confers on the contractor not only the duty to carry out the work but the corresponding right to be able to complete the work which it contracted to carry out. To take away or to vary the work is an intrusion into and an infringement of that right and is a breach of contract."[6]

He then added:

> "The basic bargain struck between the employer and the contractor has to be honoured, and an employer who finds that it has entered into what he might regard as a bad bargain is not allowed to escape from it by the use of the omissions clause so as to enable it then to try and get a better bargain by having the work done by somebody else at a lower cost once the contractor is out of the way (or at the same time, if the contract permits others to work alongside the contractor)."[7]

Stephen J followed the same rationale in a High Court of Australia's decision in *Commissioner for Main Roads v Reed & Stuart Pty Ltd*:[8]

> "… the contractor, as successful tenderer, should have the opportunity of performing the whole of the contract work."[9]

The integrity of a contract does not allow either party to change the scope of rights and obligations unless the contract expressly provides otherwise. Moreover, even where a contractual clause gives the contracting party unilateral power to vary the rights and obligations or terminate the whole contract, the approach of courts demonstrates that such power is not completely unfettered. Therefore, when

[5] *Abbey Developments Ltd v PP Brickwork Ltd* [2003] EWHC 1987 (QB); [2003] C.I.L.L. 2033.
[6] *Abbey Developments* [2003] C.I.L.L. 2033 [45].
[7] *Abbey Developments* [2003] C.I.L.L. 2033 at [47]. See also *Van Oord UK Ltd v Dragados UK Ltd* [2020] CSOH 87; [2020] CSOH 87; *Stratfield Saye Estate Trustees v AHL Construction Ltd* [2004] EWHC 3286 (TCC).
[8] *Commissioner for Main Roads v Reed & Stuart Pty Ltd* [1974] 131 C.L.R. 378 HC (Australia).
[9] *Commissioner for Main Roads* [1974] 131 C.L.R. 378 at [382].

the termination for convince clause is used to replace a contractor with a cheaper one, common law courts consider it an act of bad faith[10] because, in a sense, it deprives the first contractor of his right to complete the work.

3. General principle of prohibition: what is the test?

There are several cases in which omitting a contractor's scope of work or applying termination for convenience to procure the work elsewhere have been prohibited. In *Multiplex Construction (UK) Ltd v Cleveland Bridge UK Ltd*,[11] the court confirmed the *Abbey* principle by stating that:

> "Absent specific provision to that effect, a variation clause does not entitle the employer to omit work for the purpose of giving it to another contractor."[12]

In the US case of *Krygoski Construction Co v United States*,[13] a contractor and the US (through the Detroit District of the Army Corps of Engineers) entered a contract for the removal and disposal of asbestos contamination from an abandoned US Air Force airfield. Further surveys and tests showed that additional costs were required to remove contamination from the floor tiles, and the employer considered a price increase of this dimension a cardinal change in the contract; therefore, the contracting officer followed a general policy of terminating the contract for the convenience of the government and appointed another contractor to complete the work. The court said:

> "A contracting officer may not terminate for convenience in bad faith, for example, simply to acquire a better bargain from another source. When tainted by bad faith or an abuse of contracting discretion, a termination for convenience causes a contract breach."[14]

The primary test used by the courts to prohibit the termination of a construction contract to be given to another contractor is the test of "good faith and fair dealing". However, the English courts, in giving priority to the principles of freedom of contract and the binding force of contracts, were hostile toward the doctrine of good faith. Lord Ackner said in *Walford v Miles*:[15]

> "… the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations … and … unworkable in practice."[16]

Nevertheless, in keeping pace with other common law jurisdictions, the High Court's decision in *Yam Seng Pte Ltd v International Trade Corp Ltd* led to the recognition of an implied duty of good faith in the performance of contracts.[17] In

[10] Marilyn Warren, "Good Faith: Where Are We At?" (2010) 34(1) *Melbourne University Law Review* 344.
[11] *Multiplex Construction (UK) Ltd v Cleveland Bridge UK Ltd* [2008] EWHC 2220 (TCC).
[12] *Multiplex Construction* [2008] EWHC 2220 (TCC) at [1553].
[13] *Krygoski*, 94 F.3d 1537 (Fed. Cir. 1996).
[14] *Krygoski*, 94 F.3d 1537 (Fed. Cir. 1996), at 1541.
[15] *Walford v Miles* [1992] 2 A.C. 128; [1992] 2 W.L.R. 174 HL.
[16] *Walford* [1992] 2 A.C. 128 at [138]. See also *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] Q.B. 433 at 439; [1988] 2 W.L.R. 615 CA (Civ Div). Michael Bridge, "Doubting Good Faith" (2005) 11 *New Zealand Business Quarterly* 430 at 450: "There is no general duty of good faith and fair dealing in English contract law and there is no reason why there should be".
[17] *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111 (QB); [2013] 1 Lloyd's Rep. 526. Per Leggatt J at [148]: "as the basis of the duty of good faith is the presumed intention of the parties and meaning of their

the US, the principle of good faith has been well-established and welcomed by courts and statutes.[18] The Uniform Commercial Code (UCC), which was first promulgated in 1951 and has been adopted by many states, proclaims in s.1-203 that "every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement". Similarly, the Restatement (Second) of Contracts states in s.205 that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement". The recognition of good faith in the US is applauded by legal scholars and described as "one of the truly major advances in American Contract Law during the past fifty years".[19]

In the significant case of *Bhasin v Hrynew*,[20] the Supreme Court of Canada ruled that:

> "… good faith contractual performance is a general organizing principle of the common law of contract which underpins and informs the various rules in which the common law, in various situations and types of relationships, recognizes obligations of good faith contractual performance …"[21]

Unlike the Canadian approach, the High Court of Australia has been silent about the doctrine of good faith and has not yet clarified its position on the common law of Australian contract law, although clear recognition of the duty of good faith in a substantial body of Australian case law can be identified.[22] Scottish courts also support a broad principle of good faith and fair dealing,[23] which is similar to the approach taken by New Zealand's courts.[24]

To find out why exercising termination for convenience to replace a contractor for a cheaper one can be an act of "bad faith", one must look into the definitions and conceptualisation of good faith, which, despite the wide recognition of the principle, have been controversial. It is believed that a precise definition of good faith is elusive, and it is recommended to identify specific strands of the concept.[25] Similarly, it is said that good faith is a moral obligation for contracting parties, and when it comes to the case law, it is best understood as an excluder that excludes many heterogeneous forms of bad faith; as such, it is a phrase without a general

contract, its recognition is not an illegitimate restriction on the freedom of the parties to pursue their own interests. The essence of contracting is that the parties bind themselves in order to co-operate to their mutual benefit". At [153]: "I respectfully suggest that the traditional English hostility towards a doctrine of good faith in the performance of contracts, to the extent that it still persists, is misplaced."

[18] *Wigand v Bachmann-Bechtel Brewing Co*, 222 NY 272, 118 NE 618 (NY 1918): "Every contract implies good faith and fair dealing between the parties to it". *Brassil v Maryland Casualty Co*, 210 NY 235; 104 NE 622 (NY 1914): at 241, "There is a contractual obligation of universal force which underlies all written agreements. It is the obligation of good faith in carrying out what is written". *Industrial & General Trust, Ltd v Tod*, 180 NY 215; 73 NE 7 (NY 1905) at 225, 226: "The law requires the exercise of good faith, and no matter how strong the provision to shield from liability may be, there is no protection unless good faith is observed".

[19] Robert S. Summers, "The General Duty of Good Faith—Its Recognition and Conceptualization" (1982) 67 *Cornell Law Review* 811.

[20] *Bhasin v Hrynew* 2014 SCC 71.

[21] *Bhasin v Hrynew* 2014 SCC 71 at [33]. See also Shannon O'Byrne and Ronnie Cohen, "The Contractual Principle of Good Faith and the Duty of Honesty in Bhasin v. Hrynew" (2015) 53(1) *Alberta Law Review* 1.

[22] *Renard Constructions (ME) Pty v Minister for Public Works* (1992) 44 N.S.W.L.R. 349; *Royal Botanic Gardens and Domain Trust v Sydney City Council* (2002) 186 A.L.R. 289; *Alcatel Australia Ltd v Scarcella* (1998) 44 N.S.W.L.R. 349; *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NWSCA 187; *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15.

[23] *Smith v Governor and Company of the Bank of Scotland* [1997] UKHL 26.

[24] *Bobux Marketing Ltd v Raynor Marketing Ltd* [2001] NZCA 348, at 17 per Thomas J: "In my view, therefore, the courts would be prepared to import into the contract in issue an obligation on the parties to perform the contract in good faith."

[25] Anthony Gray, "Unfair Contract Terms: Termination for Convenience" (2013) 37(1) *University of Western Australia Law Review* 237.

meaning of its own.[26] However, good faith is not devoid of meaning,[27] and the parties involved in a contract should know when the use of the TFC clause may constitute a breach of good faith. Moreover, understanding the meaning of good faith helps judges to realise when this "safety valve" should be activated to fill gaps and qualify or limit rights and duties that would otherwise arise under specific contract language.[28]

Many judges have expressed that good faith merely requires "honesty".[29] Therefore, when a contracting party exercises discretion based on a contract, they are obliged to respect honesty; otherwise, they may breach the implied covenant of good faith.[30] The Uniform Commercial Code also defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing".[31] On the other hand, it is argued that limiting good faith to honesty is wrong because good faith excludes many forms of contractual bad faith beyond dishonesty. Furthermore, honesty is a moral concept, while many judges believe that contractual bad faith is not necessarily immoral at all.[32] Regarding the TFC clause, when a party misuses its power to terminate a building contract to get a better deal, it does not intend to mislead or deceive the other party, which is an explication of acting dishonesty. Professor Gray confirms this analysis in his article, claiming that "I am not suggesting that a party exercising a termination for convenience clause is acting dishonestly".[33]

The second meaning of good faith that has attracted the attention of judges and scholars is "reasonableness".[34] Whether performing a contractual obligation or exercising contractual power, good faith and fair dealing require both parties to respect reasonable expectations of one another and permit the other party to enjoy the benefits of the contract.[35] Therefore, it is argued that the difference between the principle of good faith and reasonableness is rhetorical and that they essentially amount to the same thing.[36] Others, however, believe that there are cases in which

[26] Robert S. Summers, "Good Faith" in "General Contract Law and the Sales Provisions of the Uniform Commercial Code" (1968) 54(2) *Virginia Law Review* 196–198. Summers further said that (p.215): "If an obligation of good faith is to do its job, it must be open-ended rather than sealed-off in a definition. Courts should be left free … to deal with any and all significant forms of contractual bad faith, familiar and unfamiliar".

[27] Reinhard Zimmermann and Simon Whittaker (eds), *Good Faith in European Contract Law* (Cambridge University Press, 2000), p.699.

[28] M.P. Ellinghaus, "In Defense of Unconscionability" (1969) 78(5) *The Yale Law Journal* 779–780.

[29] *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2003] UKHL 6, [2003] 2 Lloyd's Rep. 61 at 15; *Strzelecki Holdings Pty Ltd v Cable Sands Pty Ltd* [2010] WASCA 222; *United Group Rail Services Ltd v Rail Corporation New South Wales* [2009] NSWCA 177 at [71]; Suzanne Corcoran, "Good Faith as a Principle of Interpretation: What is the Positive Content of Good Faith?" (2012) 36 *Australian Bar Review* 1, 3.

[30] *Locke v Warner Bros., Inc*, 57 Cal. App. 4th 354, at 367 (Cal. Ct. App. 1997). See also Sons of *Thunder v Borden, Inc*, 690 A.2d 575 (NJ 1997): "despite presence of termination clause, purchaser breached obligation of good faith in terminating contract because of lack of honesty of fact".

[31] UCC § 1-201(b)(2), as amended (2003).

[32] Robert S. Summers, "Good Faith" in "General Contract Law and the Sales Provisions of the Uniform Commercial Code" (1968) 54(2) *Virginia Law Review* 204.

[33] Anthony Gray, "Unfair Contract Terms: Termination for Convenience" (2013) 37(1) *University of Western Australia Law Review* 237.

[34] *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228, per Warren CJ at [3]: "a duty of good faith is no more than a duty to act reasonably in performance and enforcement"; Johan Steyn, "Contract Law: Fulfilling the reasonable expectations of honest men" (1997) 113 *Law Quarterly Review* 433 at 439: "there is not a world of difference between the objective requirement of good faith and the reasonable expectations of parties".

[35] Hugh Collins, "Implied Terms: The Foundation in Good Faith and Fair Dealing" (2014) 67(1) 2014 *Current Legal Problems* 311. See also: Catherine Mitchell, "Leading a Life of Its Own? The Roles of Reasonable Expectation in Contract Law" (2003) 23(4) *Oxford Journal of Legal Studies* 639; Anthony Mason, "Contract, Good Faith and Equitable Standards in Fair Dealing" (2000) 116 *Law Quarterly Review* 66.

[36] Scott Crichton Styles, "Good Faith: A Principled Matter" in A.D.M. Forte (ed.), *Good Faith in Contract and Property Law* (Hart Publishing, 1999), p.168.

a person acted in good faith but, nevertheless, acted unreasonably; therefore, the core principle underlying the notion of good faith is "being conscience".[37] When a person exploits a position of dominance or power over another person who is relatively vulnerable, unconscionable conduct may be constituted.[38]

While there seems to be a great deal of overlap among the aforementioned concepts,[39] the economic conceptualisation of good faith provided by Professor Burton is especially relevant to the exercise of the termination for convenience clause. By entering a contract, parties give up some of their freedom of action and, probably, the opportunity to take advantage of cheaper options, which Professor Burton calls "forgone opportunities". If either party tries to recapture forgone opportunities after the execution of the contract, they are said to have acted in bad faith.[40] The limitation described by Burton is also consistent with the reasonable performance of a contract. The use of the TFC clause to find a cheaper deal and decrease the costs of a construction project go beyond the reasonable expectations of parties since a reasonable person would not confer such discretion to be used to recapture forgone opportunities.[41] On the other hand, when the express term of a contract provides for unlimited TFC, it is doubtful whether the principle of freedom of contract prevails over the implied covenant of good faith because all purposes, including the use of TFC clause to procure building work elsewhere, have been considered by the parties at the time of contracting. It seems that common law courts rarely impose the doctrine of good faith "in a manner that would override express contractual provisions".[42] I will look further into this matter in s.4 below.

It should be noted that, in addition to the principle of good faith, other criteria have been mentioned by the courts to prevent employers from shopping for lower prices after a contract has been concluded. The "purpose" test set down in *Abbey* and showing a "specific intent to injure" and "change in circumstances" are among the tests used to limit the application of the TFC clause.[43] However, the good faith test has been the major and most popular test used by the courts of common law jurisdictions to examine the legitimacy of exercising the TFC clause under commercial contracts.

4. Express TFC clause defying good faith

There are two schools of thought regarding the implied duty of good faith. Some believe that good faith is rooted in the parties' agreement, meaning the parties

[37] Jane Stapleton, "Good Faith in Private Law" (1999) 52(1) *Current Legal Problems* 8.

[38] Stapleton, "Good Faith in Private Law" (1999) 52(1) *Current Legal Problems* 7.

[39] Adam Wallwork, "A requirement of good faith in construction contracts?" (2004) 20(4) *Building and Construction Law Journal* 266. See also Paul MacMahon, "Good Faith and Fair Dealing as an Underenforced Legal Norm" (2015) 99(6) *Minnesota Law Review* 2091: "Conceivably, good faith and fair dealing really stands for two norms: a norm of honesty and a norm of reasonableness. At a higher level of abstraction, however, the honesty norm might be folded into the reasonableness norm: reasonableness requires honesty."

[40] Steven J. Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith" (1980) 94(2) *Harvard Law Review* 373. See also *Greer Properties Inc v LaSalle Nat. Bank*, 874 F.2d 457 (7th Cir. 1989): "When the Sellers entered the contract with Greer and Greer agreed to pay them a specific price for the property, the Sellers gave up their opportunity to shop around for a better price. By using the termination clause to recapture that opportunity, the Sellers would have acted in bad faith".

[41] Steven J. Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith" (1980) 94(2) *Harvard Law Review* 387.

[42] *Arton Holdings Ltd et al v Gateway Realty Ltd*, 106 NSR (2d) 180 at 198.

[43] Artie McConnell, "Bad Faith as a Limitation on Terminations for Convenience: As Bad as They Say, or Not So Bad?" (2003) 32(2) *Public Contract Law Journal* 411–429.

involved in a contract can change or even abandon it. On the other hand, some hold that good faith is a legal principle and that contracting parties cannot alter it by their contract. Believing in the first view makes the principle of freedom of contract prevail, and the execution of TFC to engage a cheaper contractor is justified as an express contractual term. However, the second point of view indicates that even an express contractual term cannot change the principle of good faith, and in any case, exercising the TFC clause to assign the work to a cheaper contractor is considered a breach of contract.

(i) Good faith as a contractual matter

Many courts and scholars believe that good faith performance is judicially imposed as a matter of contractual interpretation consistent with the parties' intentions, not by the operation of law.[44] This represents a compromise between the principle of freedom of contract and the principle of good faith and fair dealing. In other words, the good faith standard is a concept that can be modified by the parties should they so choose, and the courts generally respect the bargain struck by the parties but will "put the burden of careful contract planning on the discretion-exercising promisor who wishes to depart from the [good faith] norm because such a promisor is in the best position to secure the expectations of both parties".[45]

Common law courts are reluctant to "police" the substantive fairness of a bargain which is arguably consistent with the function of contracts in a capitalist economy.[46] Despite respecting the principle of freedom of contract, the main justification stated by the courts is the confrontation of express terms and implied terms of contracts, which always ends with the victory of the express terms. The role of an implied duty of good faith is only gap-filling, and when there is an explicit TFC clause in a contract, there is no gap for good faith to fill. The following statement of Easterbrook J in the significant case of *Kham & Nate's Shoes v First Bank of Whiting*[47] has been followed by US courts in several subsequent cases:

> "This is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document. 'Good faith' is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties. When the contract is silent, principles of good faith … fill the gap. They do not block use of terms that actually appear in the contract."[48]

[44] Shannon Kathleen O'Byrne, "Good Faith in Contractual Performance: Recent Developments" (1995) 74(1) *Canadian Bar Review* 82.

[45] Steven J. Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith" (1980) 94(2) *Harvard Law Review* 403.

[46] Joseph M. Thomson, "Good Faith in Contracting: A Sceptical View", in A.D.M. Forte (ed.), *Good Faith in Contract and Property Law* (Hart Publishing, 1999), p.69. See also *EFT Commercial Ltd v Security Change Ltd*, 1992 SC 414, at 424: "It is the function of the court to enforce contracts according to the bargain which the parties have made for themselves. It is not for the court to interfere in order to modify a bargain which one of the parties later considers to be unfair".

[47] *Kham & Nate's Shoes No.2, Inc v First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990).

[48] *Kham & Nate's Shoes No.2, Inc v First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990), at 1357. See also: *Milford-Bennington Railroad Co v Pan Am Railways Inc*, 695 F.3d 175 at 179 (1st Cir. 2012): "Under the circumstances, MBR cannot rely on the duty of good faith and fair dealing to restore a right that it bargained away by agreeing to the [Agreement] [citations omitted]"; *Pasadena Live, LLC v City of Pasadena*, 114 Cal. App. 4th 1089, 8 Cal. Rptr. 3d 233 (Cal. Ct. App. 2004); *Wootton Enterprises, Inc v Subaru of America, Inc*, 134 F.Supp. 2d 698 (D. Md. 2001); *Bay Fireworks, Inc v Frenkel Co, Inc*, 359 F.Supp. 2d 257 (EDNY, 2005).

This traditional "textualism" approach expresses that good faith cannot be invoked to modify contractual terms or restrict contractual powers and, therefore, has a very limited scope of application.[49] Accordingly, even the UCC's rule [§ 1-302(b) (2013)] that provides for the immutability of good faith has been criticised for being somewhat difficult to justify.[50] From this perspective, if a contract provides an owner with absolute discretion to apply TFC, the contractor would be unable to resort to the principle of good faith to override or modify this specific contractual term. This explicit term of the contract demonstrates that the contractor's expectations are duly met and that, by concluding the contract, they considered all contingencies, including the application of the TFC clause by the owner in order to take advantage of a cheaper option offered to him.

However, the method of interpretation of a contract by textualists has not been immune to criticism. It has been argued that "By reverting to a textualist approach, we renounce not only community standards, but also other external circumstances pertaining to contract interpretation, like external evidence of actual intentions, prior course of dealing, or course of performance. In fact, a fervent retreat to strict textualism would trivialize the very doctrine of good-faith performance".[51] Furthermore, most building contracts are contracts of adhesion ("take it or leave it"), and contractors are unable to change any terms or conditions. When the bargaining power of parties is not equal, a construction contract cannot reflect the true intentions and expectations of the contractor, which ultimately undermines the reasonableness of the contract. In *Carr v JA Berriman Pty Ltd*,[52] Fullagar J stated that the absolute discretion of the architect in exercising the TFC clause is subject to reasonableness, and if such power used to hand over any part of the contract to another contractor, it would be a most unreasonable use of power. He said:

> "The building owner announces that he has engaged another contractor to carry out a large part of the work comprised in the contract. A reasonable man could hardly draw any other inference than that the building owner does not intend to take the contract seriously, that he is prepared to carry out his part of the contract only if and when it suits him."[53]

In addition to the criticisms mentioned above, common TFC clauses almost always contain an absolute discretion for one of the parties that, under the textualism approach, leaves no room to invoke the implied duty of good faith. It seems this was the concern in 1999 editions of FIDIC Books. Sub-Clause 15.5 of all the FIDIC Books gives the employer an absolute right to terminate a contract "for his convenience". This sub-clause is identical in the Red, Yellow and Silver Books. However, all the Books expressly prohibit the employer from terminating the contract "in order to execute the Works himself or to arrange for the Works to be

[49] Alan D. Miller and Ronen Perry, "Good Faith Performance" (2013) 98(2) *Iowa Law Review* 696. See also *Carma Developers, Inc v Marathon Development California, Inc*, 2 Cal. 4th 342; 6 Cal. Rptr. 2d 467; 826 P.2d 710 (Cal. 1992) at 374: "We are aware of no reported case in which a court has held the covenant of good faith may be read to prohibit a party from doing that which is expressly permitted by an agreement. On the contrary, as a general matter, implied terms should never be read to vary express terms".

[50] Paul MacMahon, "Good Faith and Fair Dealing as an Underenforced Legal Norm" (2015) 99(6) *Minnesota Law Review* 2107.

[51] Alan D. Miller and Ronen Perry, "Good Faith Performance" (2013) 98(2) *Iowa Law Review* 696, 745.

[52] *Carr v JA Berriman Pty Ltd* [1953] HCA 31.

[53] *Carr v JA Berriman Pty Ltd* [1953] HCA 31 at [22].

executed by another contractor".[54] Adding this exception to the general power of the employer in applying the TFC clause shows that the authors of the FIDIC Books were worried about the downplay of the duty of good faith in common law courts and, correctly, chose to restrict the TFC clause through an express contractual condition.

(ii) Good faith as a matter of law

According to the second view, the obligations stemming from the implied covenant of good faith and fair dealing are imposed by law as normative values of society such that it is separate from those consensually agreed upon by the parties.[55] Even an absolute discretionary authority should not be exercised arbitrarily, unreasonably or capriciously with the objective of preventing the other party from receiving its reasonably expected benefits as described in the contract. "Such risks clearly would be beyond the expectations of the parties at the formation of a contract when parties reasonably intend their business relationship to be mutually beneficial".[56] This approach is taken by several US courts, especially in cases involving disparity of bargaining power between parties.[57] This approach would also be compatible with that taken by international conventions and instruments such as the CISG, the UNIDROIT Principles and the Principles of European Contract Law, all of which consider good faith as a foundational principle.[58]

On the other hand, some courts could not be convinced that the doctrine of good faith is capable of overriding the principle of freedom of contract. In finding a solution, however, they resorted to "public policy" to prevent the circumvention of good faith by an explicit contractual condition. Therefore, it is believed that when a contract provides for an at-will termination, it may contravene a clear mandate of public policy, which is a tortious breach of contractual obligations.[59]

This so-called "contextualist" view has also been criticised as not being favourable in common law, and the obligation of good faith performance will be more appealing if it is more readily subject to modification by the contracting parties.[60] Moreover, the prime source for finding the parties' legitimate expectations

[54] Unfortunately, this limitation has been removed in subsequent editions of the Books.

[55] *Koehrer v Superior Court*, 181 Cal. App. 3d 1155, 226 Cal. Rptr. 820 (Cal. Ct. App. 1986) at 1169.

[56] *Wilson v Amerada Hess Corp*, 168 NJ 236, 773 A.2d 1121 (NJ 2001) at 251.

[57] *Schlobohm v Spa Petite, Inc*, 326 NW2d 920 (Minn. 1982) at 923: "Where there is a disparity of bargaining power between the parties, Exculpatory clauses will not be enforceable". See also: *Emerson Radio Corp v Orion Sales Inc*, 253 F.3d 159 at 170 (3rd Cir. 2001): "New Jersey law also holds that a party to a contract can breach the implied duty of good faith even if that party abides by the express and unambiguous terms of that contract if that party acts in bad faith or engages in some other form of inequitable conduct" [citations omitted]; *Travellers Int'l AG v Trans World Airlines*, 41 F.3d 1570 (2d Cir. 1994): at 1575: "Even when a contract confers decision-making power on a single party, the resulting discretion is nevertheless subject to an obligation that it be exercised in good faith"; *Wells Fargo Bank, NA v Khan, Civil Action No.12-cv-00681-WYD-CBS* (D. Colo. 20 Dec. 2012) at 8; *Carvel Corp v Diversified Management Group*, 930 F.2d 228 (2d Cir. 1991); *Cross Cross Properties v Everett Allied Co*, 886 F.2d 497 (2d Cir. 1989).

[58] Bruno Zeller, "Good Faith—Is it a Contractual Obligation?" (2003) 15(2) *Bond Law Review* 238.

[59] *Tate v Browning-Ferris, Inc*, 833 P.2d 1218, 1225 (Okla. 1992); *Federated Elec v Kessler*, 131 Wis. 2d 189, 388 NW 2d 553 (Wis. 1986). See also Alan D. Miller and Ronen Perry, "Good Faith Performance" (2013) 98(2) *Iowa Law Review* 693: "the prevailing view in American courts is that a disclaimer of the common-law duty of good faith violates public policy, and therefore has no legal effect". Thomas A. Diamond and Howard Foss, "Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery" (1996) 47(3) *Hastings Law Journal* 585 at 627: "Courts have the power to prohibit or invalidate conduct that violates public policy, regardless whether the conduct is authorized by the contract".

[60] E. Allan Farnsworth, "Good Faith Performance and Commercial Reasonableness under the Uniform Commercial Code" (1962) 30(4) *University of Chicago Law Review* 678.

and intentions is the express terms of the contract, and the core function of the duty of good faith is to protect expectations and intentions "that do not necessarily find expression in the parties' formal agreement".[61] Therefore, if a contract is comprehensive and unambiguous, parties' expectations could be easily discerned, and imposing the duty of good faith would be an excessive interference with the contract which has never been expected by the parties.

(iii) A moderate approach

The above discussion raises challenges and disagreements when the notion of good faith conflicts with the apparent force of an express contractual term. Considering that the TFC clause is often an express term of building contracts and provides for the absolute power of employers to terminate such contracts for any reason at any time, the described dichotomy in decisions of common law courts extended to the exercise of the TFC clause and created confusion in the law. Therefore, "a grant of authority allowing the defendant to exercise his 'sole discretion' regarding an aspect of performance should not suffice. The term has an equivocal meaning. It is possible the parties understood it to mean that defendant has unfettered discretion and is not subject to the constraints of the covenant of good faith. It can also be understood to mean that the defendant has the exclusive power to determine the manner of performance but is not free to ignore the plaintiff's interests totally in deciding how to exercise that discretion".[62]

The author of this article believes that a moderate approach can be taken to respect the principle of freedom of contract and simultaneously limit the absolute discretion of employers to exercise the TFC clause to replace one contractor with a cheaper one. To avoid the unpredictable interpretation of the TFC clause by the courts, the parties ought to define the scope of the TFC clause and whether it includes a situation where the employer intends to replace the contractor. When contracting parties clearly reject the power of the employer to apply the TFC clause in order to replace the contractor (like in the 1999 edition of the FIDIC Books) or when such power is granted to the employer, the parties' intentions and expectations are duly met, and they can eschew the maze of good faith and its application. Therefore, construction lawyers recommend that "if an owner is intending to use a termination for convenience clause in order to complete the work itself or give the work to another contractor, the termination for convenience clause should expressly state this right".[63]

Since the obligation of good faith and TFC clauses have a long history in the US, much of the case law on these subjects comes from this country. The same challenge between the two notions may also be raised in the UK, though it seems that UK courts believe that the parties' intentions outweigh the duty of good faith.[64]

[61] Michael P. Van Alstine, "Of Textualism, Party Autonomy, and Good Faith" (1999) 40(4) *William & Mary Law Review* 1281.

[62] Thomas A. Diamond and Howard Foss, "Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery" (1996) 47(3) *Hastings Law Journal* 585 at 627.

[63] Joanna Pugsley and Nick Christopoulos, "Drafting Effective Termination for Convenience Clauses" (2006) *Australian Construction Law Newsletter* 43.

[64] *Yam Seng* [2013] 1 Lloyd's Rep. 526 at [148] and [149]: "a further consequence of the fact that the duty is based on the parties' presumed intention is that it is open to the parties to modify the scope of the duty by the express terms of their contract and, in principle at least, to exclude it altogether".

Australian state courts have also been struggling with the question of whether an implication of good faith is to be made as a matter of contract or law and have arrived at inconsistent conclusions.[65] Therefore, it is argued that the Australian case law does not give much guidance on good faith as a limit on TFC clauses,[66] which makes it necessary for the employer and the contractor to have a full and frank discussion at the contract drafting stage regarding the circumstances in which the principal may exercise the relevant power, including completing the remaining parts of the works itself or by engaging another contractor.[67]

5. Three types of TFC clauses

In the conflict between the TFC clause and the doctrine of good faith, three broad categories of termination for convenience clauses can be identified based on the actual words used in the drafting of the clause. In the first category, the clause plainly provides that a principal "can terminate for convenience" or "can terminate by written notice". The implication of good faith has the widest impact on this type of TFC clause, and common law courts usually consider it as an act of bad faith if it is exercised to engage another contractor. In the second category, the power granted to the employer is unambiguous and without restriction. For example, the clause may state that the employer can exercise the TFC clause at their "sole discretion" or "at any time and for any reason". As described above, this category is the main cause of conflicts because some courts believe that such an absolute and unfettered discretion cannot be modified by the duty of good faith and that the employer may apply TFC even with the purpose of replacing the contractor; meanwhile, other courts believe that good faith should limit the absolute power of the employer to use TFC to engage another contractor.

In the third category, the scope of the employer's powers is defined by the express wording of the TFC clause, inter alia, the power to terminate the contract to replace the contractor. It would be unexpected for the courts to interfere with such clear language in the contract by invoking the duty of good faith. Such an express clause also helps the contractor to calculate and plan for the risk of triggering the TFC clause by the employer, although the contractor may increase the price of the contract to cover such a risk.[68]

6. Conclusion

Termination for convenience initially emerged as a wartime necessity but was later extended to regular commercial contracts, including building contracts. A few justifications for the inclusion of the TFC clause in construction contracts include the government's need to manage public budgets, maintain flexibility in state

[65] William Dixon, "Termination for Convenience or not?" (2017) 45(3) *Australian Business Law Review* 232. See also S.A. Christensen and W.D. Duncan, *The Construction and Performance of Commercial Contracts* (Federation Press, 2014), p.65.

[66] Ruth Loveranes, "Termination for convenience clauses" (2012) 14 *University of Notre. Dame Australia Law Review* 113. See also Howard Munro, "The 'Good Faith' Controversy in Australian Commercial Law: A Survey of the Spectrum of Academic Legal Opinion" (2009) 28 *University of Queensland Law Journal* 167.

[67] Albert Monichino QC, "Termination for convenience: Good faith and other possible restrictions" (2015) 68 *Building and Construction Law Journal* 86–87.

[68] Loveranes, "Termination for convenience clauses" (2012) 14 *University of Notre Dame Australia Law Review* 104.

contracts and avoid obligations when a project is abandoned or when the employer does not wish to take the risk of terminating for cause.[69] In practice, however, employers exercise the TFC clause for other reasons, including to take work away from one contractor in order to have the work done at a lower price.

The application of the TFC clause to replace a contractor has created controversies and debates in contract law, as this action conflicts with some contractual rights and the doctrine of good faith. A contractor has the right to receive the benefits of the contract by completing the entire work, as they rely on the contract and allocate all of their resources to the project. Therefore, exercising the TFC clause to replace a contractor with a cheaper one has been considered an act of bad faith that leads to a breach of contract.

Where the TFC clause is an express term of a contract, another conflict has been raised between the express term and the duty of good faith. This article demonstrates that the effect of good faith on the TFC clause depends on the drafting style of this provision such that "the owner and contractor must be quite careful that the language chosen fulfils their expectations and that the result is an effective clause".[70]

[69] Ellis Baker, Ben Mellors, Scott Chalmers and Anthony Lavers, *FIDIC Contracts: Law and Practice* (Routledge, 2009), p.439.

[70] Jason L. Richey, "Termination for convenience clause: a powerful weapon in contractual disputes", by K&L Gates partner, 2007, available at: *https://www.klconstructionlawblog.com/2007/12/the-termination-for-convenience-clause-a-powerful-weapon-in-contractual-disputes/* [Accessed 4 October 2022].