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Construction contracts in the system of German Civil law

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Part III. The risk arising from the lapse of time:
Construction contracts as contracts with an extended
period of performance

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Extended performance period – really?





Agenda

- I. Extended performance period – really?**
- II. Flow of remuneration**
- III. Employer’s right to terminate**
- IV. Employer’s right to amend object of contract**
- V. Contractor’s and employer’s securities**



Extended performance period – really?

Section 631 Typical contractual duties in a contract to produce a work

(1) By a contract to produce a work, a contractor is obliged to produce the promised work and the customer is obliged to pay the agreed remuneration.



Extended performance period – really?

- I. **Extended period of production vs. momentary acceptance**
 1. Key obligation “to produce the promised work” necessarily extending over time



Extended performance period – really?

I. Extended period of production vs. momentary acceptance

1. Key obligation “to produce the promised work” necessarily extending over time
2. But:
 - a) Contractor’s performance only depending upon result
 - b) Payment only due upon acceptance, sec. 641(1) 1 GCC
 - c) Passing of risk only with acceptance, sec. 644(1) 1 GCC



Extended performance period – really?

I. Extended period of production vs. momentary acceptance

1. Key obligation “to produce the promised work” necessarily extending over time
 - Yet, production only a necessary preparatory stage to achieve owed result
 - Technically exchange of performances upon acceptance is as momentary in a works contract as in a sales contract



Extended performance period – really?

I. Extended period of production vs. momentary acceptance

1. Key obligation “to produce the promised work” necessarily extending over time
 2. In any instance, works contracts are concluded for performance in the future
 3. Changes of
 - facts
 - legal framework
 - needs of employer may occur
- Legislator has reacted to this feature



Flow of remuneration

Section 641 Due date of remuneration

(1) The remuneration must be **paid upon acceptance** of the work.



Flow of remuneration

I. Contractor's duty to advance performance, sec. 641(1) GCC

1. Payment due upon acceptance implies duty to advance performance of contractor
=> Depending upon time of production severe burden for contractor
2. In construction contracts there is typically no "natural" security for the contractor's claim, as the owner of the plot of land directly benefits from the market value of the contractor's performance ("*superficies solo cedit*"; sec. 946 GCC)



Flow of remuneration

- I. Contractor's duty to advance performance, sec. 641(1) GCC**
- II. Mitigated by employer's duty to make part payments, sec. 632a GCC**



Flow of remuneration

Section 632a Part payments

(1) The contractor may demand a part payment from the customer for the value of the work performed by him and owed according to the contract [...]



Flow of remuneration

- I. Contractor's duty to advance performance, sec. 641(1) GCC**
- II. Mitigated by employer's duty to make part payments, sec. 632a GCC**
 1. Only value of performances already rendered;
 - a) no advance payment (part payment \neq advance payment!)
 - b) No part performance (part payments require final statement of account and discount of part payments)
 2. Value to be established by contractor



Employer's right to terminate

- I. **What if, in the course of performance, the employer loses interest in the works?**
 1. Damages for anticipatory breach of contract leads to full protection of contractor's economic interests
 2. But: employer is forced into unlawful ("breach") economic behavior
 3. Historic legislator found this inappropriate
 - Accepted legitimate interest of the employer to get out from under the contract
 - But: Protected economic interest of contractor!



Employer's right to terminate

Section 648 Right of termination of the customer

The customer may terminate the contract at any time up to completion of the work. If the customer terminates the contract, then the contractor is entitled to demand the agreed remuneration; however, he must allow set-off of the expenses he saves as a result of cancelling the contract or acquires or wilfully fails to acquire from other use of his labour. [...]



Employer's right to terminate

- I. What if, in the course of performance, the employer loses interest in the works?
- II. General right to terminate the contract, sec. 648 GCC
 1. Employer's right to terminate
 - a) Not bound to any specific grounds ("free")
 - b) Until completion
 - c) Termination "*ex nunc*":
 - (1) Contractor remains liable for the work produced thus far
 - (2) Final statement of account; employer owes remuneration for work produced thus far



Employer's right to terminate

- I. What if, in the course of performance, the employer loses interest in the works?**
 - II. General right to terminate the contract, sec. 648 GCC**
 1. Employer's right to terminate
 2. Contractor's right to full remuneration!
 - a) except savings actually incurred due to early termination
 - b) except savings that contractor negligently failed to incur
- => full protection of contractor's profit margin!



Employer's right to terminate

- I. What if, in the course of performance, the employer loses interest in the works?**
- II. General right to terminate the contract, sec. 648 GCC**
 1. Employer's right to terminate
 2. Contractor's right to full remuneration except savings
 3. Termination of construction contracts valid only in written form, sec. 650h GCC



Employer's right to amend object of contract

I. Sometimes employers' needs change in the course of the construction

- **Ex.:** The employer intends to build a family home. Due to another child being born there is need for another room.
- **Ex.:** The employer intends to build a shopping mall. A lease contract with a tenant operating electronics markets fails. Instead the employer makes a lease contract with a fitness gym requiring better ventilation, locker rooms and showers instead of many electric power lines, data cables etc.



Employer's right to amend object of contract

- I. Sometimes employers' needs change in the course of the construction
- II. Sometimes the requirements change
 - **Ex.:** The legal provisions for energy savings have changed and the building now needs additional insulation.



Employer's right to amend object of contract

- I. Sometimes employers' needs change in the course of the construction**
- II. Sometimes the requirements change**
- III. Sometimes the requirements are only identified in the course of the performance**
 - **Ex.:** The employer has contracted for an industrial building in which he wants to operate very heavy printing machines. The list of specifications only foresees normal grade concrete for the floor. The contractor has advised that the normal-grade concrete as specified will not carry high loads, and that more expensive high-grade concrete is required instead.



Employer's right to amend object of contract

I. Necessities to adapt the contract

The contractors' view:

“Make better plans!”

“Decide first what you really want!”



Employer's right to amend object of contract

I. Necessities to adapt the contract

The contractors' view:

- In some instances more anticipation is helpful, but in many instances it is not cost-efficient.



Employer's right to amend object of contract

I. Necessities to adapt the contract

II. "Pacta sunt servanda"

1. General private law does not hold available instruments to unilaterally change the contract
2. Adaptation due to an interference with the basis of the contract, sec. 313 GCC, only in very rare cases
3. Severe hold-up problem created!



Employer's right to amend object of contract

I. Necessities to adapt the contract

II. "Pacta sunt servanda"

Ex.: The employer intends to build a shopping mall. A lease contract with a tenant operating electronics markets fails. Instead the employer makes a lease contract with a fitness gym requiring better ventilation, locker rooms and showers instead of many electric power lines, data cables etc.

- The full contract over a volume of 5 m EUR has a profit margin of 500.000 EUR for the contractor
- The amendment would cost EUR 10.000 in planning and more 200.000 EUR in additional costs, and yield 10.000 EUR in savings: 200.000 EUR
- Changing after completion would cost 10.000 in planning, 200.000 in additional costs and 100.000 in extra costs of tear down and removal. 310.000 EUR



Employer's right to amend object of contract

I. Necessities to adapt the contract

II. "Pacta sunt servanda"

Ex.: The employer intends to build a shopping mall. A lease contract with a tenant operating electronics markets fails. Instead the employer makes a lease contract with a fitness gym requiring better ventilation, locker rooms and showers instead of many electric power lines, data cables etc.

- Lost savings (EUR 10.000) + extra costs of tear down (EUR 100.000) create huge potential of extortion: in terms of economics the employer would have to be ready to pay up to extra (!) EUR 110.000 for any contract for a change
- Early change for appropriate remuneration much more efficient:
- Total remuneration EUR 200.000 for extra costs and EUR 20.000 surcharge for appropriate profit



Employer's right to amend object of contract

I. Necessities to adapt the contract

II. "Pacta sunt servanda"

1. General private law does not hold available instruments to unilaterally change the contract
2. Adaptation due to an interference with the basis of the contract, sec. 313 GCC only in very rare cases
3. Severe hold-up problem created!
4. Addressed since 1926 by secs. 1(3), (4) resp. 2(5), (6) VOB/B
5. Today governed by secs. 650b-d GCC



Employer's right to amend object of contract

I. Necessities to adapt the contract

II. "Pacta sunt servanda"

III. Distinction of changes under the obligations of the contract and changes going beyond the obligations

1. Changes under the obligations of the contract, sec. 650b(1) no. 2 GCC, generally have to be accepted by the contractor

Ex.: The contractor has advised the employer that the concrete specified in the contract will not be sufficient for heavy machinery, and that higher-grade concrete is required. The employer then has an unlimited right to order the use of higher-grade concrete.



Employer's right to amend object of contract

I. Necessities to adapt the contract

II. "Pacta sunt servanda"

III. Distinction of changes under the obligations of the contract and changes going beyond the obligations

1. Changes under the obligations of the contract, sec. 650b(1) no. 2 GCC, generally have to be accepted by the contractor
2. Changes going beyond the obligations of the contract, sec. 650b(1) no. 1 GCC, only have to be accepted, if the change is tolerable for the contractor. However, in a dispute the contractor has to show the reasons why this is intolerable



Employer's right to amend object of contract

- I. Necessities to adapt the contract**
- II. "Pacta sunt servanda"**
- III. Distinction of changes under the obligations of the contract and changes going beyond the obligations**
- IV. Legal grounds for additional remuneration, sec. 650c GCC**

Yet, the employer's right to unilaterally change the object of the contractor's obligation shall not change the subjective equivalence of performances

=> Sec. 650c GCC grants additional remuneration

- a) Additional costs \cdot /. saved costs +
- b) Appropriate surcharges for risk and profit



Employer's right to amend object of contract

I. Necessities to adapt the contract

II. "Pacta sunt servanda"

III. Distinction of changes under the obligations of the contract and changes going beyond the obligations

IV. Legal grounds for additional remuneration, sec. 650c GCC

1. The employer's right to unilaterally change the object of the contractor's obligation shall not change the subjective equivalence of performances
2. Sec. 650c GCC grants additional remuneration
3. No more speculative pricing ("I spy with my little eye")!



Employer's right to amend object of contract

- I. Necessities to adapt the contract**
- II. “Pacta sunt servanda”**
- III. Distinction of changes under the obligations of the contract and changes going beyond the obligations**
- IV. Legal grounds for additional remuneration, sec. 650c GCC**
- V. Keep the cash flowing, sec. 650d GCC!**
 1. If the parties are in dispute over the tolerability of the change or the amount of the additional remuneration, they may seek interim measures
 2. Urgency is presumed, sec. 650d GCC
 3. Part payments are owed including extra remuneration



Contractor's and employer's securities

I. Contractor's securities

1. Mortgage of a building contractor, sec. 650e GCC
 - a) Requires real property of employer, hence not available for sub-contractors
 - b) Only "right to" => needs enforcement => slow
 - c) Contractor typically last in line to get a mortgage on the plot of land, after financing banks!
- Rather weak instrument!



Contractor's and employer's securities

I. Contractor's securities

1. Mortgage of a building contractor, sec. 650e GCC
2. Builder's security, sec. 650f GCC
 - a) Only requires claim to remuneration => available also for sub-contractors
 - b) Typically given by a bank suretyship => more flexible and speedy than mortgage
 - c) But: Contractor has to pay costs of security



Contractor's and employer's securities

I. Contractor's securities

II. Employer's securities

1. Less need due to advance performance of contractor
2. But: risk of consequential damage
3. Bank suretyships for performance and/or conformity with the contract common in B2B contracts
4. Gap for B2C contracts; current project of legislation

