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Chile: Trends & Developments

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Trends and Developments

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Fleischmann & Román Abogados

Fleischmann & Román Abogados is a boutique law firm that specialises in construction, infrastructure, public work concessions, litigation, arbitration and dispute resolution, in which its lawyers have a vast experience and a professional trajectory. The firm is routinely engaged to assist clients in the management of disputes and contracts, to secure the interests of its clients and settle differences among the parties. In addition, the firm has long-term experience in domestic litigation and arbitration, as well as in-

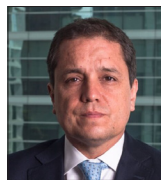
ternational arbitration, mainly related with construction contracts and commercial disputes. As the practice is deeply rooted in the development of high-stake projects (many in the area of public work concessions), the firm is constantly engaged by international clients who require a Chilean contact that has relevant, practical and day-to-day knowledge regarding the industry and the role of the Chilean government (one of the most relevant acting in this field).

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Hernán Fleischmann of Fleischmann & Román Abogados is specialised in civil and construction law, negotiation, and national and international litigation and

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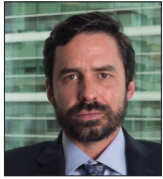


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Orlando Palominos of Fleischmann & Román Abogados specialised in the resolution of national and international arbitration disputes, mainly in commercial

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Recent Case Law Developments in Out-of-Court Termination of Contracts

In recent years, case law and, particularly, decisions of the Chilean Supreme Court have been particularly relevant to contemporary improvements and have become a beacon to various methods of practice. 2023 was particularly important in terms of case law on the form and effects of out-of-court termination of contracts.

Although Chilean law neither fully regulates nor provides specific rules regarding out-of-court contract termination, today there is a consensus on the issue that it would be lawful for the parties to agree to an early termination clause, because a party has the legal right to terminate a contract before its agreed termination without the need of a judgment order.

On the other hand, an issue that continues to be problematic is one related to the way in which these clauses are exercised; and that relates to the destination of the outstanding obligations after the termination, particularly in cases in which the parties have not included a detailed regulation of these issues in the relevant contract. However, as the cases that will be presented show, even when the parties themselves have foreseen the form and effects of the termination, Chilean courts have resorted to general principles of law, including contractual good faith, to correct what the parties have expressly foreseen and agreed to.

Bearing that in mind, this is a summary and analysis of some of the most relevant 2023 decisions to illustrate how Chilean courts address early termination issues and, particularly, obtain certain principles or general rules, criteria and conclusions that consolidate the process that every party should adhere to if it aims to terminate a contract early.

Expert evidence to prove higher costs for hiring a third party to complete unfinished work on a project and the concept of replacement work

On 11 July 2023, the Supreme Court upheld the judgment of the Court of Appeals of Valparaíso that had dismissed the claim for damages brought by the Municipality of Santo Domingo against the construction company Puerto Principal.

Summary of the case

The conflict that was the subject of the lawsuit dates back to 2017, when the municipality of Santo Domingo contracted with the company Puerto Principal for the construction of a new townhall building.

In 2019, due to a series of breaches attributed to Puerto Principal, the municipality decided to terminate the contract and immediately afterwards requested compensation for the following damages: (i) increased costs of hiring a third party to complete the unfinished work; (ii) expenses for site preparation and cleaning; (iii) costs resulting from assumed labour payments due to the workers of Puerto Principal; and (iv) costs of remaining in the old building and not being able to rent commercial space or compromise the parking lot of the new building.

The court of first instance dismissed the claim, stating in its judgment that although Puerto Principal's breach of contract had been proven in the proceedings, the municipality had not been able to prove the resulting damages. Specifically, regarding the increased costs incurred (the first item claimed), the court held that to prove such damages it was essential to obtain expert evidence to determine which of the services contracted to the new construction company could

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be substituted for the one originally contracted with Puerto Principal.

In other words, only expert evidence, which was not provided by the municipality, would have made it possible to determine which expenses were technically related to the damage resulting from the hiring of a third party to carry out the unfinished works of the project. An appeal was lodged against the decision of the first instance, but the appeal was rejected, and the decisions were upheld.

Hearing the recourse against the second judgment, the Supreme Court upheld the reasoning of the first and second instance courts, adding that although the plaintiff in the second instance court had submitted documentary evidence of the costs incurred by the new company for the completion of the works, the higher costs incurred in the execution of a project cannot be calculated by simple arithmetic operations and require the relevant expert evidence.

Analysis of the case

This decision highlights the importance of expert evidence to establish, in a construction dispute, the increased costs corresponding to the payment of a third party for the completion of unfinished works.

In fact, as is clear from the reasoning of the judgment that the quantification of these concepts could not be left to the judge's calculation by means of simple arithmetic operations – for example by means of simply adding up charts, invoices or receipts – the Supreme Court recognised the technical nature at stake, concluding that the analysis of their calculation and origin is only possible by means of expert evidence.

On the other hand, it should be pointed out that in the above-mentioned ruling, the Supreme Court implicitly recognised as an indemnifiable item the so-called substitute or replacement operations, a concept that has found a more complete treatment in the comparative doctrine and that refers to the possibility for the creditor to satisfy its interests originally pursued in the contract by means of the performance of the unfulfilled and uncompleted obligations by a third party. This decision confirms that, in the event of non-performance, the creditor can turn to other market players to carry out projects and then obtain the corresponding compensation for the extra costs that it had to bear.

The construction contract and the corrective function of good faith in the payment of the price

On 30 June 2023, the Supreme Court, following a recourse lodged by Eldu SpA, decided *ex officio* to annul a second instance arbitration award insofar as it ordered the defendant (Eletrans SA) to pay some milestones of the construction contract that were originally rejected.

Summary of the case

The case submitted to the Supreme Court concerns the out-of-court termination by Eletrans SA of a contract concluded with Eldu SpA for the design, supply, construction, installation, testing and commissioning of a long-distance transmission system.

As a result of this termination, Eldu SpA claimed damages in court, including the payment of the contract price in proportion to the progress of the works, which amounted to almost 70%.

Eletrans SA, in turn, claimed that the contract did not provide for a payment formula proportional to the progress of the works, but, on the

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contrary, according to the fulfilment of certain milestones to be documented by Eldu SpA that were not related to the physical advancement of the works. As a result of this milestone payment formula (as laid down in the contract), Eletrans SA paid a sum of almost 40% of the total price.

In the first instance, an arbitral tribunal agreed with the interpretation proposed by Eldu SpA and ordered the payment of the actual advancement of the works (70%). However, the arbitral tribunal of second instance, in a final judgment, held that there had been no breach by Eletrans SA of its obligation to pay the contract price.

Hearing a disciplinary recourse filed by Eldu against the arbitral tribunal that issued the award, the Supreme Court ruled that it was not acceptable and was therefore against the general principle of good faith, under the pretext of a strict interpretation of the terms of a contract, especially when this leads to a manifestly unfair result.

Indeed, as the Supreme Court stated in its judgment, good faith requires the parties to refrain from any conduct that would prevent the other party from obtaining the benefit it hoped to obtain from the relevant contract, which in this case consisted in receiving the payment for the work carried out, despite the milestone payment formula provided for in the contract.

Analysis of the case

The above case illustrates the important role that our courts give to contractual good faith, particularly in this case where the Supreme Court uses it as a tool to correct the content expressly and validly agreed by the parties.

Indeed, given that contracts are an instrument for the satisfaction of the interests of the par-

ties, contractual good faith imposes duties of co-operation between the parties to direct their conduct towards the mutual benefit of the contract.

In this light, the court then examined the method of payment expressly agreed by the parties in the contract, which consisted of the fulfilment of milestones not directly matched with the physical advancement of works, and found that Eldu SpA had completed 70% of the works but had received in return for that progress only 40% of the agreed price.

With this inconsistency firmly in mind, the Supreme Court ruled in favour of Eldu SpA, and it is possible to conclude that the Supreme Court emphasised the principle of good faith over and above the express terms of the contract, in an instance in which strict compliance with what the parties had agreed would have led to an unfair or inequitable result for one of the parties. This conclusion is of the utmost importance, as it would mean that, under certain circumstances, strict adherence to a contract would not suffice to uphold the position of the parties in the event of controversy.

Finally, it is relevant to mention that this decision also deals directly with arbitration and the finality of awards. Indeed, the Supreme Court heard about this case after a disciplinary recourse (*recurso de queja*) filed against the second instance award and, although it rejected this recourse as it concluded that arbitrators had not issued an award with manifest disregard of the law (*falta o abuso grave*), it annulled the judgment *ex officio* based on a matter of contract and law interpretation.

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Unilateral termination of contracts without cause and duty to state reasons

On 31 July 2023, the Supreme Court of Justice, hearing a recourse filed by the Corporación Nacional del Cobre de Chile (Codelco), upheld the judgment given in the first instance in favour of Codelco in an action for damages filed by the company Mol Ambiente SA.

Summary of the case

The dispute in question arose from the exercise by Codelco of a unilateral contract termination clause, which could be exercised without stating the reasons to terminate the contract, thus terminating a transport and storage services contract awarded to the company Mol Ambiente SA. Codelco notified its decision to terminate the contract, in accordance with the provisions of clause 30 of the General Administrative Principles, due to persistent and profound differences in the interpretation of the contract.

Mol Ambiente SA denounced the unlawfulness of the termination of the contract as a breach of contract because, in its opinion: (i) the unilateral termination would constitute a modification of the contract contrary to clauses 14, 15 and 20 of the contract; (ii) Codelco would have invoked a ground that was not foreseen or included in the contract; and (iii) even if the clause invoked was considered to be valid, the early termination would not be a termination without a statement of reasons, as provided for in the clause, since a reason was actually included in the termination decision.

After confirming the validity of this type of agreement, the Supreme Court pointed out, firstly, that the clause invoked was valid and enforceable; and, secondly, the Supreme Court concluded that the unilateral termination was not, in any way, tantamount to a modification of the con-

tract, since such an option is clearly a ground for terminating the contractual relationship.

However, the Supreme Court went further and concluded that, when such clauses are exercised, it is also necessary for the courts to determine whether they have been exercised rationally and without arbitrariness, since the legal system rejects arbitrariness and requires the execution of contracts in good faith.

In short, the Supreme Court considered that Codelco's justification for exercising the unilateral termination clause, based on disagreements over the interpretation of the contract, was sufficient and free of any arbitrariness that could have given rise to damages. In particular, the Supreme Court added that the reasonability of the said ground was finally reflected during the proceeding, in which the parties showed disagreement over the scope of the obligation to make certain payments, among other issues.

Analysis of the case

The above case illustrates the treatment that our courts have given to so-called "unilateral termination without cause clauses".

In fact, although the need for justification of unilateral termination clauses was initially linked by our courts to the performance of these types of clauses, the case presented here represents a step forward in the matter, in which the justification of the decision to terminate is not addressed from the point of view of its exercise or performance, but to determine the indemnifiable nature of possible damages that may arise from its exercise.

In fact, as is clear from the judgment, the parties may agree on this type of clause and even invoke it without the need to state a reason.

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However, the Supreme Court seems to provide an extra layer of analysis as regards to determining if such termination may give rise to damages claims when it is exercised arbitrarily or with serious disregard for the interests of the other party.

In the case analysed, Codelco's justification was contained in the act of termination itself and consisted of a difference in interpretation of the contract, which was considered sufficient by the Supreme Court, thus preventing any damages claim. This is relevant because, firstly, from the point of view of the standard of sufficiency, the Supreme Court seems to be quite flexible (eg, normally this type of claim would involve differences in contractual interpretation); and, secondly, it shows that, regardless of how the clause is drafted, it seems advisable that the party who exercises the termination of the contract justifies the termination in so doing.

Retention of machinery by the principal and self-guarantee

On 4 July 2023, the Supreme Court of Justice accepted a protection action (*recurso de protección*) filed by the contractor Consorcio Belaz Movitec SA (Movitec) against the National Copper Corporation of Chile (Codelco), in which the former alleged violation of constitutional guarantees at the time of the unilateral termination of the contract that bound them.

Summary of the case

The case arose out of a major earthworks contract for the preparation and construction of roads concluded between Codelco and Movitec, which was subsequently unilaterally terminated by Codelco by means of a notice. In connection with the early termination of the contract, Codelco also collected certain bank guarantees provided by Movitec.

Exceptionally, Movitec filed a *recurso de protección* against Codelco's decision to collect guarantees, among other behaviours: (i) Codelco's withholding of funds related to payment statement No. 23, although they should have been released, as this instrument was not objected to according to the terms of the contract itself; (ii) Codelco's withholding of other funds related to bills of exchange recognised and accepted by Codelco; (iii) as a result of these withholdings, Codelco exerted pressure to obtain the signing of a series of mandates in its favour, with the purpose of carrying out, in its name and on its behalf, acts such as the payment of suppliers and the movement of machinery (demobilisation).

The Supreme Court found that Codelco, by means of communications not originally considered in the contract, made the demobilisation of Movitec's machinery located on its land conditional on the signing of two separate mandates, one for the demobilisation of the equipment and the other for the payment of the SMEs and local suppliers. In the meantime, Codelco was to retain Movitec's assets.

After analysing the case, the Supreme Court established that Codelco had no title whatsoever to justify its possession of the machinery owned by Movitec and that the demand to make Movitec's return possession of the machinery conditional on the signing of said mandates was arbitrary and, ultimately, an act of self-protection prohibited by the Chilean legal system.

Then, regarding the withholding of funds from payment statement No. 23, the Supreme Court ruled that this document had not been contested by Codelco in accordance with the terms of the contract; therefore there was no contractual ground to retain the payment. Moreover, the

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Supreme Court added that the contract contained an arbitration clause which, in the event of a dispute, did not allow the unilateral suspension of the performance of obligations by the parties. Thus, the court reasoned that such a withholding of funds would also be an act of self-protection in violation of Movitec's property rights. Accordingly, the Supreme Court partially accepted the *recurso de protección* filed by Movitec.

Analysis of the case

Although the Supreme Court does not analyse contractual issues in detail, given the constitutional purpose of the *recurso de protección*, the characterisation of Codelco's behaviour as self-protection allows important conclusions to be drawn.

The first one is that, according to the relevant circumstances and the provisions of the contract, no party to a contract would be allowed to retain goods belonging to the party to whom the contract has been terminated without a legitimate right of possession, let alone make their delivery conditional on the performance of another contract or agreement not originally considered or agreed in the terminated contract.

In addition to the above, it is possible to read between the lines of the judgment a clear appeal by the Supreme Court to contractual good faith, particularly regarding post-contractual obligations arising from the termination of the contract, which would be in line with the previous decisions agreed herein.

Indeed, the Supreme Court emphasises that good faith is a principle that is present throughout the contractual period, including the period after the termination of the contract. Therefore it seems from the decision that the Supreme Court may have concluded that Codelco would have acted against good faith and did not behave as a loyal and honest contracting party after the termination of the contract, particularly when it tried to take advantage of the fact that the machines were still on its land and made the delivery of the machines conditional on the signing of other contracts.

Conclusion

To sum up, 2023 has been an interesting year in terms of case law development, particularly in connection with long-term contracts and adherence to good faith. In such regard, the courts have recognised the validity and enforceability of clauses that allow termination of contracts early. A different approach in connection with the consequences of those terminations is sometimes required to appease predictable antagonisms, be it in relation to the damages resulting from said termination, the rights of the terminated party to receive payment of works and services performed, and the rights and obligations of both parties to continue respecting good faith and honouring the contract and the principles of honesty and loyalty, even after the contract has been terminated.

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