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To Boot, or Not to Boot - That is the Question

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INTRODUCTION

Songwriter Bret Michaels is quoted as having said “Thoroughly read all your contracts. I really mean thoroughly.” Ideally, the time to put this sentiment to use is before the contract is executed. This is particularly true with regard to the time to assess the adequacy of a termination for cause provision in a construction contract. However, during the contract formation phase, most parties are focused on performance rather than on possible breach. When a default termination is being considered, you can be sure that everyone will spend a considerable amount of time reading and re-reading their contract language, even if the contract is one of the construction industry’s most widely used standard forms and the parties are somewhat familiar with the termination provisions included in it. At such times, both the factual history of the project and the familiar contract terms will take on a whole new light and significance.

Basic principles of contract law are at issue in any termination for cause situation. Just because they are basic, however, does not mean that they are straightforward or clear cut. This paper will discuss termination for cause provisions in general, discuss the legal standards applied by the courts reviewing terminations for cause, and discuss the factors that come into play when an owner contemplates taking action to terminate a contract for cause when it is authorized by the terms of the owner’s contract but may not make practical or legal sense given the uncertainty of how the action may be interpreted with the benefit of hindsight under amorphous legal standards.

GROUND TO TERMINATE A CONTRACT FOR CAUSE

What is termination? At its most basic, termination is a contractual remedy invoked by one party that bars, at least partially, the other party's right to continue performing and to
continue to receive the benefits of the contract. The contract itself is not terminated. "One party
to a contract may violate it – break it, so to speak; but does it not require all to lawfully rescind it?" Abraham Lincoln, First Inaugural. Thus, termination is very different than rescission.

When one party commits a material and substantial breach of the contract and the other party, in response, seeks to terminate the first party, the contract itself is not being terminated or rescinded. When termination is invoked, the non-breaching party is terminating the breaching party's further employment under the contract. The contract rights of the non-breaching party are not being forfeited. Rather, the non-breaching party still expects to obtain the benefits of its bargain under the contract, but is saying that it will no longer accept performance from the breaching party. The performance will have to be rendered through monetary damages or a third party, such as a replacement contractor or surety.

There can be many reasons for terminating a construction contract, but the basic premise is grounded upon the owner’s belief that the contractor has not performed according to its contractual obligations. Not every failure to perform constitutes a breach of contract, and, even if there is a technical breach of the contract, not every breach entitles the owner to terminate the contract. An example of this situation is where the contractor is delayed in the completion of the project, but the delay is excusable because of impracticality, a force majeure or some other event beyond its control. In such a situation, the contract terms provide for the appropriate remedy, i.e., a time extension or excused performance.

Some of the most common reasons cited for a default termination are failure to perform the work in a timely manner, failure to perform the work in accordance with the plans and specifications, and failure to repair or replace unacceptable work. Not communicating with an owner or disregarding the authority of the owner’s engineer or architect may also provide
grounds for termination of a contractor. Section 108-9 of the North Carolina Department of Transportation Standard Specifications for Roads and Structures, January 2012 Edition, provides an example of contract language that describes conduct that may be considered a material term or condition of the contract and a material breach if not performed.

108-9 DEFAULT OF CONTRACT

(A) Declaration of Default

The Department shall have the right to declare default of the contract for breach by the Contractor of any material term or condition of the contract as determined by the Department. Material breach by the Contractor shall include, but specifically shall not be limited to failure to begin work under the contract within the time specified; failure to provide workmen, equipment, or materials adequate to perform the work in conformity with the contract by the completion date; unsatisfactory performance of the work; refusal or failure to replace defective work; failure to maintain satisfactory work progress; failure to comply with equal employment opportunity contract requirements; insolvency or bankruptcy, or any act of insolvency or bankruptcy; failure to satisfy any final judgment within 10 calendar days after entry thereof; and making an assignment for benefit of Chapter 13 creditors.

Another commonly used termination clause is found in the AIA Document A201 – 2007, General Conditions of the Contract for Construction:

§ 14.2 TERMINATION BY THE OWNER FOR CAUSE

§ 14.2.1 The Owner may terminate the Contract if the Contractor
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.1 repeatedly refuses or fails to supply enough properly skilled workers or proper materials;
.2 fails to make payment to Subcontractors for materials or labor in accordance with the respective agreements between the Contractor and the Subcontractors;
.3 repeatedly disregards applicable laws, statutes, ordinances, codes, rules and regulations, or lawful orders of a public authority; or
.4 otherwise is guilty of substantial breach of a provision of the Contract Documents.

§ 14.2.2 When any of the above reasons exist, the Owner, upon certification by the Initial Decision Maker that sufficient cause exists to justify such action, may without prejudice to any other rights or remedies of the Owner and after giving the Contractor and the Contractor’s surety, if any, seven days’ written notice, terminate employment of the Contractor and may, subject to any prior rights of the surety:
.
.1 Exclude the Contractor from the site and take possession of all materials, equipment, tools, and construction equipment and machinery thereon owned by the Contractor;
.2 Accept assignment of subcontracts pursuant to Section 5.4; and
Finish the Work by whatever reasonable method the Owner may deem expedient. Upon written request of the Contractor, the Owner shall furnish to the Contractor a detailed accounting of the costs incurred by the Owner in finishing the Work.

§ 14.2.3 When the Owner terminates the Contract for one of the reasons stated in Section 14.2.1, the Contractor shall not be entitled to receive further payment until the Work is finished.

§ 14.2.4 If the unpaid balance of the Contract Sum exceeds costs of finishing the Work, including compensation for the Architect’s services and expenses made necessary thereby, and other damages incurred by the Owner and not expressly waived, such excess shall be paid to the Contractor. If such costs and damages exceed the unpaid balance, the Contractor shall pay the difference to the Owner. The amount to be paid to the Contractor or Owner, as the case may be, shall be certified by the Initial Decision Maker, upon application, and this obligation for payment shall survive termination of the Contract.

Other examples of termination for cause provisions from various sources are attached in the Appendix to this paper to illustrate their similarities as well as their differences. These include Article 15 of the EJCDC Standard General Conditions of the Construction Contract, and Title 48, Chapter 1, Subchapter H, Part 52.249.10 of the Code of Federal Regulations, entitled Default (Fixed-Price Construction) to show the mandated language on projects that are federally funded.

**THE MEANING OF MATERIAL BREACH**

The language in these provisions identifies the action or inaction on the part of the contractor that may be used to support the owner’s conclusion that termination is warranted. Whether termination is warranted is generally a question of whether the breach relied upon rises to the level of a material breach. Whether the action or inaction occurred or did not occur is a question of fact that can be answered by examination of the evidence in a particular situation. Stated simply, the required performance either happened or it did not happen. But the fact of performance or nonperformance itself does not answer the question of whether the action or inaction constitutes a material breach.
Case law attempts to provide guidance in determining what constitutes a “material” breach by using buzz words like “go to the root of the matter,” or “defeat the object of the agreement” to analyze breaches. Restatement (Second) Contracts § 241 also provides guidance for analyzing whether a material breach justifies termination for cause, but even the title and the lead-in sentence show the text will not define the term or specify the elements required to establish the materiality.

§ 241 Circumstances Significant in Determining Whether a Failure is Material

In determining whether a failure to render or to offer performance is material, the following circumstances are significant:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;

(b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;

(c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;

(d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;

(e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

This resource really does no more than set out factors that the party entertaining the notion of exercising termination rights should consider before it takes that action. Comment (a) to § 241 acknowledges as much when it states that the standard of materiality is necessarily impractical and flexible, and is to be applied in the light of the facts of each case and in such a way as to further the purpose of securing for each party its expectation of performance. The Comment emphasizes that these are circumstances, not rules, to be considered in determining whether a particular failure of performance is material.
For an owner seeking certainty when evaluating its risk of making an election to terminate a contractor for cause, this does not provide much comfort. Every owner that finds itself in the situation of contemplating termination probably goes through some variation of this exercise even without knowing Restatement (Second), Contracts § 241 exists. Indeed, sophisticated owners who can appreciate the delays and increased costs associated with terminating an original contractor and finding a replacement contractor, even without a legal challenge, evaluate the totality of the circumstances sometimes even before they call their attorney for assistance.

In *L.L. Lewis Construction, LLC v. Adrian*, 142 S.W.3d 255, (Mo. Ct. App. 2004) the court analyzed the dispute between an owner and a contractor in the context of the five factors set forth in § 241 of the Restatement Second, Contract. In that case, the court concluded the contractor had materially breached the construction contract and the owner was justified in refusing to make payment and in refusing to allow the contractor to return to the work site. The court’s lengthy analysis is set out below.

The first factor, the amount of benefit lost by the Adrians, weighs in favor of a finding of material breach. In terms of remodeling their home, the Adrians wanted to create their “dream home,” a home that they could live in and be proud of for the rest of their lives. They chose to remodel their existing home rather than build a new home, in part, because they wanted to preserve the hardwood floors in their existing home. Rather than obtaining their “dream home,” however, the Adrians were left with a home that was structurally unsound and significantly damaged by the weight of the addition….See *Restatement (Second) of Contracts section 241* cmt. b (“In construction contracts, for example, defects affecting structural soundness are ordinarily regarded as particularly significant.”).

The second factor, the adequacy of compensation, also weighs in favor of a finding of material breach because money damages in this case are inadequate to sufficiently compensate the Adrians for their entire loss. While many of the problems created by Lewis' defective performance were cosmetic and, therefore, compensable by monetary damages, the evidence also demonstrated that the deflection in the wood flooring could not be adequately repaired short of tearing
the floors out and starting over. In some places of the Adrians' hardwood flooring, Lewis' work caused up to a quarter of an inch separation between the wood laths of the flooring. The Adrians made the decision to remodel their existing home rather than build a new home, in part, because they wished to preserve their wood floors since the same quality of flooring was unavailable today. Thus, damages will not adequately compensate the Adrians for the loss of their hardwood flooring.

The third factor, the amount of forfeiture by Lewis as the breaching party, also weighs in favor of a finding of material breach. The parties stipulated that the Adrians paid progress payments to Lewis totaling $71,908.15. Thus, potential forfeiture by Lewis is mitigated. See Restatement (Second) of Contracts section 241 cmt. d (“potential forfeiture may be mitigated if the builder ... has already received progress payments under a provision of the contract”). Moreover, while Lewis billed the Adrians a total of $107,090.27, leaving an unpaid balance of $35,182.12, at trial, Lewis was only able to produce receipts and invoices totaling $99,756.13. Some of the items included in these invoices, however, were for other jobs or were not proper expenses under the contract. And, while the contract, here, was a cost-plus contract, the initial cost estimate for the entire remodeling project was $83,829.78. From this original cost estimate, the evidence demonstrated that numerous items were not constructed, for example: a porch, estimated to cost $7,983.91; mirrors, estimated to cost $250; carpet, estimated to cost $2500; labor for painting, estimated to cost $600; and cabinets, estimated to cost $650. Deducting these items results in a total cost estimate of $71,845.87, an amount less than the total paid by the Adrians. While additional items were added to the project, including a dormer, a loft in one bedroom, and a closet, Lewis failed to offer any evidence as to the cost of these additions. Consequently, this court finds that Lewis has failed to prove that any net forfeiture in this case would be significant.

The fourth factor, the likelihood that the breaching party will cure, also weighs in favor of a finding of material breach. While Lewis argues that the Adrians did not allow it an opportunity to cure and refused to allow it to complete the project, the evidence refutes Lewis' argument. In particular, Ms. Adrian testified that before Lewis completely quit working, they had left numerous messages with Lewis, trying to get Lewis to come out and complete parts of the renovation. There was also evidence that the Adrians informed Lewis of numerous problems that Lewis failed to rectify. For example, the Adrians told Lewis about a problem with the ceiling fan that Lewis installed in the living room, yet Lewis failed to fix the problem. The Adrians informed Lewis about the problem with the fireplace motor, yet Lewis failed *263 to fix the problem. Mr. Adrian also testified that after Lewis was notified of a problem with the dryer vent, a Lewis employee suggested attempting to fix the problem by cutting a hole in the house, which the Adrians refused to let him do. The Adrians also told Lewis about problems with the windows. Mr. Adrian testified that Lewis had a representative from the window company come out to the home to discuss the
problem, but Lewis failed to resolve the problem. Thus, the evidence sufficiently supports a finding that the Adrians allowed Lewis an opportunity to cure but, upon Lewis' failure to do so, the Adrians elected to terminate the contract.

The final factor, the extent to which Lewis' behavior comports with standards of good faith and fair dealing, also weighs in favor of a finding of material breach. In discussing "good faith performance," the Restatement defines it as "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms." Restatement (Second) of Contracts section 205 cmt. d. “[B]ad faith may be overt or may consist of inaction, and fair dealing may require more than honesty.” Id. The evidence, here, demonstrated that Lewis lacked good faith and fair dealing in its contract with the Adrians. For example, Ms. Adrian testified that some of Lewis' employees would show up unprepared and without the necessary items they needed for the day's projects. She also testified that a couple of the workers would play football, listen to music, and joke around rather than work. Yet, after she informed Lewis of these problems, no improvement occurred. Nor did Lewis properly address problems the Adrians brought to its attention. For instance, when Lewis was told that a light socket was installed on the wrong side of the door, rather than repairing the drywall, Lewis simply put a plate over the hole when it moved the light switch. Lewis over-billed the Adrians for workers' time, included items on the Adrians' invoices for other jobs, and charged the Adrians for pallet deposits without providing for corresponding credits. Lewis also billed the Adrians for interest, even though no agreement had been made between the parties for the payment of interest. This evidence sufficiently demonstrates that Lewis lacked good faith and fair dealing, as defined by the Restatement.

In sum, each of the five factors deemed significant in determining whether Lewis materially breach its contract with the Adrians weighs in favor of such a finding.

142 S.W.3d 255, 261-263.

LEGAL STANDARDS APPLICABLE TO MATERIAL BREACH

On federal projects, the government owner bears the burden of proof and must show, by a preponderance of the evidence, that the decision to terminate the contract for default was justified. Lisbon Contractors, Inc. v. United States, 828 F.2d 759, 764 (Fed.Cir.1987). It is often said that courts are averse to default terminations, but nonetheless they must “strike a balance between [this aversion] and the fact that ‘the [g]overnment, just as any other party, is entitled to receive that for which it contracted.’” 5860 Chicago Ridge, LLC v. United States, 104 Fed.Cl.
In order to prevail, “[t]he government ... must establish that the default termination was based on ‘good grounds and on solid evidence.’” Id. at 755 (quoting J.D. Hedin Constr. Co. v. United States, 408 F.2d 424, 431 (Ct.Cl.1969)). “A court's review of a default justification does not turn on the contracting officer's subjective beliefs, but rather requires an objective inquiry.” McDonnell Douglas Corp. v. United States, 567 F.3d 1340, 1355 (Fed.Cir.2009) (quoting McDonnell Douglas, 323 F.3d at 1016), vacated on other grounds, General Dynamics Corp. v. United States, — U.S. —, 131 S.Ct. 1900, 179 L.Ed.2d 957 (2011).

If the government owner meets its burden of justifying the default termination, the burden of proof shifts to the contractor to rebut the evidence that cause existed. See Lassiter v. United States, 60 Fed.Cl. 265, 268 (2004) (“Because the defendant satisfied its burden of proof, plaintiff is required to demonstrate that his nonperformance was excusable.”) (citing DCX, Inc. v. Perry, 79 F.3d 132, 134 (Fed.Cir.1996)). If the contractor satisfies his burden the termination can be converted into a termination for convenience. See FAR § 52.249–8(g) (“If, after termination, it is determined that the [c]ontractor was not in default, or that the default was excusable, the rights and obligations of the parties shall be the same as if the termination had been issued for the convenience of the [g]overnment.”).

When the government owner terminates a contractor for failure to make progress, the courts have held that the government must show “that it was reasonable for the [government] to conclude that [the contractor] would be unable to complete the project by what the Board found to be the proper completion date.” Empire Energy Management Systems, Inc. v. Roche, 362 F.3d
In Empire, the United States Court of Appeals reviewed and rejected numerous defenses advanced by Empire to challenge its termination for default by the Department of the Air Force, including arguments of excusable delay for potential civil liability related to an environmental permit, waiver of the government’s right to terminate for encouraging Empire to complete the project, a liquidated damage provision that negated the right to terminate for delay, an ineffective cure notice and the contracting officer’s failure to conduct an analysis or form a subjective belief that the conditions for default were satisfied. Id. at 1356. The case is interesting reading for a number of reasons, not the least of which is the fact that it involves a voluntary work stoppage in excess of one year and mentions the Air Force’s concerns that the contractor’s purported environmental concerns were merely a guise to support a delay claim. But it is useful to government owners defending termination for cause actions because it provides legal support for the propositions that a cure notice is not defective if it fails to specify the particular failure for which the contract might be terminated if the contractor had sufficient notice of the government’s intent to terminate the contract for a default and that the government owner is not required to conduct an analysis to support a default under the alternative theory.

As explained by the court,

“[o]ur decisions have consistently approved default terminations where the contracting officer's ground for termination was not sustainable if there was another existing ground for a default termination, regardless of whether that ground was known to the contracting officer at the time of the termination. See, e.g., Kelso v. Kirk Bros. Mech. Contractors, Inc., 16 F.3d 1173, 1175 (Fed.Cir.1994) (“This court sustains a default termination if justified by the circumstances at the time of termination, regardless of whether the Government originally removed the contractor for another reason.”); Joseph Morton Co. v.
It is settled law that a party can justify a termination if there existed at the time an adequate cause, even if then unknown.”). Thus, the subjective knowledge of the contracting officer herself is irrelevant, and the government is not required to establish that the contracting officer conducted the analysis necessary to sustain a default under the alternative theory. Id. At 1356.

*Empire* and *McDonell Douglas*, supra, 323 F.3d 1006 (Fed.Cir.2003) do not stand for the notion there are no restrictions on the government owner’s right to terminate for default. Indeed, in *McDonnell Douglas Corp. v. United States*, 182 F.3d 1319 (Fed. Cir. 1999), the Federal Court held that the government may not use a technical default by the contractor as a “pretext for terminating the contract on grounds unrelated to performance.” 182 F.3d at 1326. In this *McDonnell* case, the court distinguished *Darwin Construction Co., Inc. v. United States*, 811 F.2d, 593, 596 (Fed.Cir. 1987), where a contracting officer had terminated a contract “solely to rid the Navy of having to deal with the contractor, by explaining that *Darwin* stands for the proposition that a contracting officer’s decision to terminate for default is arbitrary and capricious when there is no nexus between the decision to terminate for default and contract performance. But in cases where the reasons for termination are directly related to performance, these cases suggest that the termination will be upheld, even if those reasons are accompanied by other influences, such as personality conflicts or personal frustrations and dislikes, which may otherwise call into question the arbitrary nature of the contracting officer’s decision to terminate.

**ACTIONS, INACTIONS AND STATES OF MIND**

For the reader who may be asking him/herself if the state of mind of either or both the breaching party or the non-breaching victim is relevant to the analysis of whether there has been a material breach, we recommend an excellent article by Eric G. Anderson entitled “A New Look at Material Breach in the Law of Contracts,” 21 U.C. Davis L. Rev. 1073 (Summer 1988).
In this article, Anderson examines contract breaches in terms of protecting interests in future performance and whether the ultimate remedy of termination is necessary to protect those interests. In the section discussing state of mind, he posits that there are two types of cases where a breach is likely to be material: 1) those in which there is doubt about the willingness of the party in breach to perform properly in the future; and 2) those in which the party’s ability to perform is in question. When exercising judgment about whether a breach is material and could justify termination, the key element is the interest in future performance and the implications of attitude on the part of the breaching party for that interest in future performance. The interest is impaired if it appears that the breach is motivated or accompanied by a state of mind suggesting that future breaches are likely. On the other hand, a state of mind indicating that future nonperformance is unlikely cuts against materiality. *Id.* at 1123.

Anderson uses two cases to illustrate deliberate conduct that in one evidenced impairment of future performance but did not in the other. In *Ylijarvi v. Brockphaler*, 213 Minn. 385, 387, 7 N.W.2d 314, 319 (1942), a land owner hired a contractor to drill a water well. Part way through the job, the contractor started using a 2 1/2 inch casing instead of the 4 inch casing the parties had agreed upon, and persisted despite the owner’s protests. The contractor’s state of mind reflected by his conduct, i.e., a deliberate breach that was accompanied by evidence of an intent to continue in the future, clearly impaired the owner’s interest in future performance.

The second case, *Oak Ridge Construction Co. v. Tolley*, 504 A.2d 1343 (Pa. Super. 1985), was another water-well case in which the owner disputed the contractor’s charges for drilling, which was part of a larger contract for construction of a house. The owner refused to pay the disputed amount, but wanted the other work to continue and was willing to pay for it. The owner’s refusal to pay was just as deliberate as the contractor’s action in *Ylijarvi*, but unless
the refusal to pay that portion of the progress payment related to the drilling made it impossible or impractical for the contractor to continue, it did not impair the interest in future performance. See also, Zancanaro v. Cross, 85 Ariz. 394, 339 P.2d 746 (1959) (developer hired contractor to install plumbing and fixtures in 50 houses, but stopped building after 25 houses were constructed and Contractor who was prevented from performing on structures that did not exist was justified in assuming developer was unwilling to perform in the future).

The state of mind of the breaching party remains relevant after the breach occurs. It is at that time that the non-breaching party will see whether the party cures the breach, attempts to do so, or at least gives assurances about proper performance in the future. Any of those actions, may eliminate the injury resulting from the breach, and reduce or eliminate liability. But more importantly, cure, or an attempt to cure, demonstrates a responsible attitude toward performance and suggests that future breaches are unlikely to occur or will be corrected if they do. And, as it relates to materiality of breach, curing a breach prevents the breach from being material.

It should come as no surprise, then, that if a party that is given the opportunity to cure fails to do so, that conduct invites precisely the opposite inference. In that situation, it is the lack of assurance about future performance that makes the absence of cure relevant to materiality. Similarly, a non-breaching party’s concerns about future performance may be quieted or aggravated depending on whether or not the breaching party gives explicit and adequate assurances about future performance.

We next turn to situations where there is a question about the breaching party’s ability to perform and how that relates to whether a breach is material. It may be the case that the party is prevented from performing present and/or future duties because of the breach, or the breach shows that the party lacks the skills and/or resources to complete the work they promised to do.
An example of the former is the breach that occurs when a general contractor which agreed to construct a project for an owner within a year dissolves its business after six months. The breach is material as it makes future performance impossible.

A more difficult situation arises when the breach does not prevent future performance, but there are concerns that the breaching party lacks the ability to fulfill the rest of its obligations. This point can be illustrated by a hypothetical fact scenario. Assume a general contractor was hired by a town to remove and construct a water line in proper workmanlike manner. During the excavation work, the contractor’s bulldozer driver got too close to an adjacent structure and caused it to collapse. In evaluating whether there is a reasonable concern about the contractor’s ability to perform the rest of the work in accordance with the contract, the owner would want to consider whether there is more earth-moving work required near buildings. Has the unskilled operator been replaced? If reasonable concerns are not addressed to the satisfaction of the owner, the breach may be material and may possibly warrant termination for cause. But if they are addressed, that conclusion would not be warranted.

There may be situations where the non-breaching/victim’s state of mind is relevant to the analysis of whether it was reasonable for that party to be concerned about the impairment of future performance by the breaching party and exercise the self-help remedy of termination. For example, recall the pretext of the Navy wishing to be rid of an undesirable contractor in Darwin Construction Co., Inc. v. United States, supra, 811 F.2d 593 (1987). See also, Continental Grain Co. v. Simpson Feed Co., 102 F. Supp. 354 (E.D. Ark. 1951) (buyer seized upon an inconsequential breach on the part of the seller as an excuse for release from the contract when the soybean market rose). See, generally, 5 Bruner & O’Connor Construction Law § 18:4 Amorphous Legal Standard of Material Breach, (July 2014).
When an owner sits down with counsel to discuss options for a problem project and a “clear” contractor default, the owner will hold up the contract language (which the owner can read as well as the lawyers) and ask if it can be enforced the way it reads. An owner that has been patient and generous to a contractor with time extensions, change orders for increased costs and accommodations for substitute materials but has long witnessed illogical means and methods and inferior or unsatisfactory performance will not be happy to hear that courts consider termination a drastic sanction and that there is a judicial aversion to default terminations. But as counsel it is our duty to explain that even if there is a “clear” default, courts want parties to resolve their differences, and negotiate a resolution that satisfies reasonable expectations while striking a balance between the risks and rewards of the contract.

**PROCEDURAL REQUIREMENTS TO TERMINATE FOR CAUSE**

Most owners and contractors will do almost anything to avoid a contract termination because they know it will cause disruption, delays, added costs and probable legal entanglements. Hopefully a notice of intent to terminate is a wakeup call and it incentivizes the contractor to fortify its efforts and resolve to complete the project. If the contractor does so, the grounds for default evaporate and the owner is prohibited from terminating the contract. See, for example, Article 15.02B and D of the 2002 edition of EJCDC Document C-700 which provides that the owner is prohibited from terminating the contract if the contractor “begins within seven days of receipt of notice of intent to terminate to correct its failure to perform and proceeds diligently to cure such failure within no more than 30 days of receipt of said notice.”

There are times, however, when notice does not lead to a cure of the material default and the owner concludes termination is the only viable solution. For example, if a contractor has abandoned the work and admitted to the owner that it does not have the financial means to
complete the project, the decision to terminate is less difficult. See, *Millis Construction Company v. Fairfield Sapphire Valley, Inc.*, 86 N.C. App. 506, 358 S.E.2d 566 (1987) (contractor’s statements that he was “busted,” “belly-up” and would be unable to complete the contract unless he received retainage to which he was not yet entitled could have constituted a repudiation and raised an issue of anticipatory breach discharging the non-breaching party.) In such a situation, notice may be simply a formality needed to start negotiating a takeover agreement with the surety.

If, after evaluating the circumstances in the context of the principles discussed above for a more complicated project or a more difficult situation, the owner concludes that termination of the contractor is necessary, it must make sure the termination is executed properly. Parties exercising default terminations should be just as concerned about challenges for ineffective termination based upon procedural mistakes as they are about claims going to the substantive basis for the default. This is especially true when the owner’s primary motivation for terminating the contractor is to get the project back on track before it spirals out of control and the owner may itself be liable for a default if it does not complete the project within the time it promised to do so. All will be for naught, and instead a tangled knot, if the owner fails to strictly comply with a condition precedent to termination and it is later held to be invalid.

**Notice and Opportunity to Cure.** An example of a typical notice provision is found with reference again to Section 108-9 of the North Carolina Standard Specifications for Roads and Structures.

**(C) Notice**

Before invoking any of the sanctions provided for herein, the Department will give the Contractor at least 7 calendar days written notice with a copy to the
Surety, that will set forth the breach of contract involved and the sanctions to be imposed. The Department, in its discretion, may grant the Contractor time in excess of 7 calendar days within which to comply with the contract and the time allowed will be set forth in writing. If the Department determines during such period that the Contractor is not proceeding satisfactorily to compliance, it may impose the sanctions after 24 hours’ notice to the Contractor. If the Department determines that the Contractor is not in compliance at the end of the time allowed, it may immediately impose any of the sanctions set forth herein and will advise the Contractor, in writing, with a copy to the Surety of the sanctions imposed.

Seven days appears to be a standard notice time period, and that is what is required in the AIA Document A201 and the EJCDC C-700 General Conditions. But note that the termination clause in CFR 52.249-6 provides for a 10 day cure period so confirm the contract language at issue to ensure compliance.

**Conditions Precedent.** On projects using the AIA Documents, the most obvious and familiar prerequisite to a termination for cause is the requirement that the owner obtain a certification by the architect on the project that there exists sufficient cause to justify termination. This condition precedent is found in Section 14.2.2 of the AIA Document A201 – 2007, and courts have held that an owner must strictly comply with this prerequisite. See *Town of Plainfield v. Paden Engineering Co., Inc.*., 943 N.E.2d 904 (Ind. Ct. App. 2011), where the court found that failure to obtain the certificate rendered the termination invalid.

Most public projects will have a performance bond and, in that case, the owner should carefully review the terms of the performance bond to make sure it satisfies all of the conditions precedent to making a claim that it is entitled to the coverage and remedies of the bond. The revised AIA312 - 2010 Performance Bond is full of traps for the unwary. For example, Paragraph 3 imposes several notice requirements upon the owner at various times both prior to and after a contractor has been terminated for default. An owner may be lulled into a false sense of comfort that its failure to strictly comply with these provisions will not defeat its bond claim.
by the language in Paragraph 4 that says the owner’s failure to comply with those notice requirements “shall not constitute a failure to comply with a condition precedent to the Surety’s obligations, or release the Surety from its obligations, except to the extent the Surety demonstrates actual prejudice.”

Another consideration in terminating a contractor (or a general contractor terminating a bonded subcontractor) where a performance bond is involved is that the technical requirements for invoking the surety's obligations under a performance bond are typically very different than the technical requirements for terminating the contractor under the contract. Compare the termination language from the AIA 201-2007 Contract quoted on pages 4-5, above, with the following language from the AIA A312 - 2010 form performance bond.

§ 3 If there is no Owner Default under the Construction Contract, the Surety's obligation under this Bond shall arise after

.1 the Owner first provides notice to the Contractor and the Surety that the Owner is considering declaring a Contractor Default. Such notice shall indicate whether the Owner is requesting a conference among the Owner, Contractor and Surety to discuss the Contractor's performance. If the Owner does not request a conference, the Surety may, within five (5) business days after receipt of the Owner's notice, request such a conference. If the Surety timely requests a conference, the Owner shall attend. Unless the Owner agrees otherwise, any conference requested under this Section 3.1 shall be held within ten (10) business days of the Surety's receipt of the Owner's notice. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default;

.2 the Owner declares a Contractor Default, terminates the Construction Contract and notifies the Surety; and

.3 the Owner has agreed to pay the Balance of the Contract Price in accordance with the terms of the Construction Contract to the Surety or to a contractor selected to perform the Construction Contract.
Even semantically, the processes are different, with the AIA Contract referring to termination of the contract and the performance bond referring to declaring a contractor default. If pursuing a termination, to invoke the Surety's obligation to perform, or both, the owner (or its attorney) must carefully review and analyze both the contract terms regarding termination and the performance bond terms and determine a course of action, including a sequence of steps, to satisfy the requirements of both the contract and the performance bond.

Support for public owners arguing the merit of the position that a surety should have to show prejudice in order to avoid its obligations under a performance bond can be found in *Kilpatrick Bros. Painting v. Chippewa Hills School District*, an unpublished opinion of the Court of Appeals of Michigan, 2006 WL 665210 (2006), that is decidedly and understandably pro-public owner all the way. A simple but compelling set of facts, unambiguous contract language, Michigan law and public policy behind surety bonds, and the inattention of a contractor and a surety all combined to support holdings that: 1) a surety’s obligation was not limited to costs incurred after the contractor was declared in default and terminated; 2) the school district did comply with the bond’s notice requirements; 3) the school district’s hiring of a replacement contractor before default and termination was not a material breach of the performance bond; and 4) the school district was not required to make an express demand of the surety for performance under the bond before hiring a replacement contractor.

In rejecting the surety’s argument that its obligations under the bond were discharged by the hiring before termination, the court cited the introductory note to the Restatement, Suretyship and Guaranty, 3d, § 36 which states

“[t]here is probably no area of suretyship law in which there is less consensus than the law of suretyship defenses.” Because “[r]ules vary from jurisdiction to jurisdiction, from context to context, and from common law to the Uniform Commercial Code,” the Restatement “seeks to rationalize this complex
area and to set forth a series of rules that flow from a common concept.” *Id.* According to the Restatement, the general rule is that if the obligee (the school district) does something that changes the risks undertaken by the secondary obligor (Merchants) as surety for the principal obligor (plaintiff), “there is the potential for a loss to the secondary obligor” that may result in the discharge of the secondary obligor's obligation under the bond. *Id. at 157, 677 N.W.2d 51.*

In the present case, Merchants seeks to be excused from its obligations under the performance bond because the school district hired contractors to correct and complete plaintiff's work before default and termination, and this, Merchants alleges, affected its ability to perform (and mitigate its damages) under ¶ 4. However, this circumstance is not among those recognized in the Restatement, § 37, that might result in the discharge of a surety's obligation. In particular, the school district did not alter Merchants's risks as defined in the Restatement, §§ 37(2), 39(c)(iii), and 41(b)(i), because it neither released plaintiff from its duties nor modified plaintiff's duties. Similarly, the school district did not violate the Restatement, §§ 37(3), 39(c)(ii), 40(b), and 41(b)(ii), because it did not impair Merchants's recourse against plaintiff. Thus, Merchants does not have a defense against the school district under the Restatement, § 37(4).

In Kilpatrick the court declined to follow cases from other jurisdictions that had allowed a surety's responsibilities to be discharged for technical violations of the bond. “[W]here Merchants cannot show a serious impairment or any resulting harm, excusing it from its obligations under the bond would bestow upon it an unwarranted windfall—at taxpayers' expense.” *Id.* at 4.

In Michigan, “[t]he ... obligation as a surety for hire is in the nature of insurance; ‘and courts in the construction of its contracts usually invoke rules applicable to contracts of insurance.’ *Detroit, supra at 266, 237 N.W. 61*, quoting *Sandusky Grain Co, supra at 311, 183 N.W. 218*; see also *Gen Electric Credit Corp v. Wolverine Ins Co (Gen Electric I ),* 120 Mich. App. 227, 233–234, 327 N.W.2d 449 (1982), aff'd 420 Mich. 176, 362 N.W.2d 595 (1984) (*General Electric II*). In the context of insurance policies,

it is a well-established principle that an insurer who seeks to cut off responsibility on the ground that its insured did not comply with a contract provision requiring notice immediately or within a reasonable time must establish actual prejudice to its position. [Koski v. Allstate Ins. Co., 456 Mich. 439, 444, 572 N.W.2d 636 (1998) .]
Accordingly, in the surety context, “[a] paid surety must demonstrate that it has been prejudiced before it will be released from its contract of guarantee.” 


Moreover, in the present case, the bond furnished by Merchants was “conditioned upon the faithful performance of the contract in accordance with the plans, specifications and terms thereof.” _MCL 129.202_. Additionally, “[t]he bond shall be solely for the protection of the governmental unit awarding the contract.” _Id_. The bond protects the governmental unit by ensuring that, “[i]f a general contractor or a subcontractor defaults on a project, the governmental unit will have economic recourse to guarantee that the project is completed.” _W.T. Andrew Co., Inc. v. Mid-State Surety Corp._, 450 Mich. 655, 668, 545 N.W.2d 351 (1996).

*6 As the school district argues, the bond does not guarantee that, at the time of default and termination, all of the options listed in ¶ 4 will be available. Merchants is bound by the terms of the bond, as written. _Blue Ribbon, supra at 266, 237 N.W. 61_.

In determining whether the school district committed a material violation of the bond that resulted in injury to Merchants, we note that, in letters dated March 2, March 13, and March 19, 2002, the school district notified plaintiff (with copies to Merchants), that it intended to hire replacement contractors if plaintiff did not correct its work and asked both plaintiff and Merchants to participate in a conference on March 22, 2002. Merchants did nothing. On April 26, 2002, the school district terminated plaintiff and offered to pay the contract balance to Merchants (or another contractor), thus satisfying ¶¶ 3.2 and 3.3 of the bond.

The trial court noted Merchants's inaction, commenting, “And why would they not be able to do that if they wanted to lay in the bushes and wait for you to screw up?” However, allowing Merchants to benefit from such conduct would be inconsistent with the bond's purpose of protecting the school district and, ultimately, would result in granting it an unwarranted windfall.

As of its May 6, 2002, letter to the school district, Merchants was admittedly aware that repair and completion work was already underway. However, Merchants did not attempt to arrange for plaintiff to complete the work (¶ 4.1), did not request to perform the work itself or through contractors (¶ 4.2), and did not attempt to obtain bids for completing the work (¶ 4.3). Instead,
Merchants indicated that it was “investigating the matter under a complete reservation of rights.” Meanwhile, the school district was faced with the reality that delays occasioned by plaintiff’s work could forestall the beginning of the 2002–2003 school year.

For a case holding that termination must take place first in time before replacement, see, Solai & Cameron, Inc. v. Plainfield Community Consolidated School District No. 202, 871 N.E.2d 944, (2007) (Surety’s duty to act nullified when the general contractor sent notice of termination after it had entered into a contract with a substitute contractor for completion of the subcontractor’s work and thereby deprived the surety of the opportunity to investigate and to perform under the conditions of the bond), citing Dragon Construction, Inc., v. Parkway Bank & Trust, 678 N.E.2d 55 (1997), one of the cases specifically rejected in Kilpatrick. See also, Archstone v. Tocci Building Corporation of New Jersey, Inc., 119 A.D.3d 497 (2014), where, with no elaboration or discussion of the facts, the court upheld summary judgment for the surety dismissing all claims asserted against it with the following simple statement: “Contrary to the plaintiff’s contention, paragraph 3 of the subject AIA A 312 performance bond contains express conditions precedent to the liability of the surety under the bond.” See also, Bank of Brewton, Inc. v. International Fidelity Insurance Company, 827 So. 2d 747 (2002) (Surety discharged form any obligation under the performance bond for delay damages when the bank threatened to terminate the contractor hired to renovate its offices, but did not comply with the conditions precedent and never did terminate the contract.)

The takeaway from this is that an owner should be cautioned that, even if all of the procedural requirements are met, the owner may find itself in a coverage dispute with a surety that relates not only to completion obligations, but also to the amount of damages that the surety can be liable for under the performance bond. One step an owner can take to increase the
likelihood of support from the surety, or increase the likelihood of a favorable ruling if the support is not provided and the surety challenges its liability, is to solicit the assistance of the surety before termination. The school district in Kilpatrick did that in its letter to the contractor and the surety giving notice of its intent to declare a contractor default; the surety did nothing and the outcome was not good for the surety.

An owner should give consideration to asking for a conference with the contractor and the surety, even if the terms of the performance bond do not mention any such option, or, like the A312 Performance Bond, make the request optional for the owner. There can be advantages to being the party that initiates a meeting with the contractor and its surety. For example, a notice letter and the conference provide the owner with the opportunity to summarize the status of the project and explain its concerns about the principle’s performance that have caused the owner to conclude it needs to terminate the contract. This is particularly true for a project that started smoothly and then slowly slid into a problem project. If the owner has observed a contractor struggling to perform acceptable work or to prosecute the work on schedule, representatives of the owner can provide examples of the actions taken by the contractor or its subcontractors that were inappropriate or inadequate and explain how tolerant, patient and reasonable the owner has been or tried to be. All parties will benefit if they can negotiate terms under which the matter is resolved, whether that is a scenario where the surety is persuaded to encourage and assist the contractor to cure the deficiencies and avoid a default, or the surety is willing to take over the project, pay the owner for any damages it has incurred, or negotiate terms for the surety to find a replacement contractor. Even if the surety denies the claim and the parties end up in a dispute over coverage under the performance bond, the owner will have satisfied the notice and cure
requirements and will avoid outright dismissal of the claim on affirmative defenses based upon procedural grounds.

An owner contemplating termination on a project without a performance bond also should review its contract carefully to ensure it complies with any express terms that set out conditions precedent to termination. The contract language may include a specific notice period and an opportunity to cure, but even if a time limitation is not prescribed, courts hearing wrongful termination claims may interpret the contract to require a reasonable notice and cure period. It is recommended that the owner conduct itself with a view toward how the owner’s actions may be construed by objective third parties and strive to be in a situation where there is no question about bad faith or ulterior motives for a threatened termination in the correspondence and interactions with the contractor and or its surety.

In summary, termination conditions are not new and the construction industry is familiar with those found in the industry contract forms. Before sending any written communications, all key contract provisions should be reviewed to understand how or if they overlap or, of more concern, how or if they possibly contradict each other. Particular attention should be paid to the cure period in the base contract and in the performance bond, if there is one, to see if they differ. Follow the prescribed process exactly, even if it is duplicative, to prevent or reduce the opportunity for the surety to argue it has no coverage. This is not the time to take any shortcuts. Public owners that administer hundreds of contracts should not assume that each termination clause is identical. Use words in the notice that state clearly and precisely that this is a default situation and count days accurately. Consider a second notice confirming that the contract has been terminated at the end of the notice period, even if it is not required by the contract.
PRACTICAL CONSIDERATIONS PRIOR TO TERMINATION

Preservation of rights and remedies. When an owner terminates a contractor for fault, the owner wants to elect a remedy that meets the goals and objectives of completing the project in the most expeditious and cost-effective manner, while preserving its rights against the original contractor and its surety. Contract language should address what actions can be taken by an owner without prejudice to any other rights or remedies. Several provisions of Section 108-9 of the NCDOT Standard Specifications illustrate contract language that confers this authority on an owner.

(B) Sanctions

In the event of a breach of the contract by the Contractor, the Department shall have the right, power and authority, in its sole discretion, without violating the contract or releasing the Surety: to assume full control of the prosecution of the contract in the place and stead of the Contractor in directing Contractor's agents, employees and subcontractors in the performance of the work and in utilizing all materials, tools, machinery, equipment and structures located on the project; to perform the work or any part thereof with Department personnel and equipment or to use any or all materials and equipment located on the project that are suitable and acceptable; to relet the work upon such terms and conditions as the Department shall deem appropriate; to employ any other methods that it may determine are required for completion of the contract in an acceptable manner; and to withhold any sums due the Contractor under the contract without penalty or interest until the work is completed and accepted by the Department.

(E) Power of Engineer

The Engineer will exercise the powers and discretion vested in him by the contract in carrying out the terms of this article. He will have full power and authority to carry out any orders, directives, or resolutions issued by the Department in connection with a declaration of default. In the event that the Department fails to specify the sanctions to be imposed, the notice to be given or the method of completing the work, the Engineer may, at his discretion, impose such sanctions, give such notice and select such methods of completing the work, as are authorized by this article; and such actions shall have the same effect and validity as if taken pursuant to an express order, directive or resolution of the Department.
(F) Obligation of Contractor and Surety

No term or terms of this article and no action taken pursuant hereto by the Department of Transportation, its agents, or employees, will be construed to release or discharge the Contractor or the Surety upon the obligation set forth in the contract bonds, and the Contractor and the Surety shall remain bound thereon unto the Department until the work set forth in the contract has been completed and accepted by the Department and all obligations of the Contractor and the Surety arising under the contract and contract bond have been discharged.

(G) Provision Not Exclusive

The provisions shall be in addition to and not in place of, any other provisions relating to default, breach of contract and sanctions to be imposed in connection therewith appearing in the contract.

Other examples of contract language preserving rights and remedies can be found in the AIA Documents General Conditions and Section 15.02 (E) of the EJCDC General Conditions.

Document Condition of Work and any Deficiencies or Defects. When termination is considered, regardless of whether the cause is failing to perform or unacceptable work, or because the project is behind schedule, the owner should consider engaging the services of a construction expert to evaluate the work or status of the project. The information and opinions of the qualified expert will or may be needed at several stages. For contracts that require an owner to have its architect or engineer certify that cause exists to terminate the contract, it will provide support for that certification. Even if certification is not required, the expert’s opinion will allow the owner to give the contractor a general description of the deficient work or proposed breach so it can elect to cure the proposed breach and avoid default and termination.

The owner also will benefit from the qualified construction expert’s advice in determining what is needed to correct and/or complete the project and the probable cost of doing so. If the contractor does not take steps to cure the proposed breach, documentation of the status of the work, including all known defects, will enable the owner to preserve its claims and help
avoid a later fight over what work the terminated contractor was responsible for before a replacement contractor takes over.

Assessment of the project condition and status by a qualified construction expert, either the project designer or an independent professional, will also enable the owner to evaluate the risks of pursuing termination and claims, and of defending against the contractor’s claim if the termination is disputed. An owner may decide it is preferable to keep the original contractor on the project rather than terminate under the default provisions after it considers such factors as the consequences of accepting a later completion date, the potential for delays associated with rebidding the remaining work, acceleration costs, and whether the amount of liquidated or actual damages will be sufficient to offset the completion costs.

**Evaluate Pros and Cons of Termination.** In a contentious situation where it appears likely the contractor will challenge the termination for cause, the owner needs to consider its risks and exposure to litigation and the consequences in terms of time and cost if it is determined that the contractor was excused or prevented from performing as required and termination was not justified. A wrongful termination for cause might be converted to a termination for convenience, however, without a termination for convenience clause. The owner may be liable to the contractor for the reasonable cost of the work performed before the termination, including profit and overhead, the anticipated profits on uncompleted work, justifiable and reasonable termination costs, including perhaps project wind-down costs, as well as the money paid to the replacement contractor for costs associated with the completion project.

When a public owner contemplates termination of a contractor for cause, the owner must consider the estimated cost to complete the project in relation to the remaining contract amount. This evaluation is obviously more complicated if there is work in place that is unacceptable and
has to be removed and replaced. If sufficient funds have been withheld from payment applications to address work that has been identified as being deficient and in need of repair or replacement, or to cover the amount of anticipated liquidated damages for delayed completion, the owner is sitting in the best financial position to consider the benefits and risks of termination as compared to simply demanding specific performance on completion or correction by the contractor. As long as there are no emergency, health or safety issues associated with the deficient or delayed work, and the owner can tolerate the practical and political consequences of late completion, i.e., manage the expectations of citizens voicing complaints about their inconvenience and of the elected officials questioning staff’s oversight and diligence, the best action an owner might take is no action at all. Sometimes it may make sense to simply wait and enforce other provisions of the contract, such as liquidated damages and back-charges for corrective work not performed by the contractor, when the project is completed.

CONSIDERATION OF ALTERNATIVES TO TERMINATION

An owner who has clear grounds to terminate a contractor for cause has a lot of power over a contractor. But every construction project, with its unique circumstances, individual characters and parties, is fertile ground for any number and nature of defenses to challenge an owner’s termination for cause. Sophisticated owners and contractors know that defending the right to terminate is just as time-consuming, disruptive and expensive as challenging the termination. For that reason, most try to avoid default termination and find a way to salvage the project and the relationship, even if there are grounds for exercising the right.

“A party to a contract faced with a breach by the opposing party, can choose either to terminate the contract or to continue the contract, perhaps extracting other concessions or consideration from the breaching party in return for its willingness to modify the contract.”
Contractors know that even if the owner does not invoke the termination clause, it has the right to pursue warranty claims and claims for breach of contract. So, it is in everyone’s interest to find creative alternatives to termination that confer real and reasonable benefits on the party that is foregoing a legal right and real and reasonable burdens on the party that is avoiding the consequences of that legal action. For example, circumstances giving rise to potential termination may provide an opportunity for the owner to negotiate a global settlement that includes more favorable close out terms, such as waivers of contractor claims and extended warranties. If a contractor is struggling to complete the project, the owner can remove scope and issue deductive change orders. An owner may accept nonconforming work, or work that will require maintenance sooner than it should anticipate if the work had been proper in exchange for contract price reduction. If the owner has held retainage and/or some progress payments for disputed or defective work, the owner can negotiate terms under which the contractor can perform the work or agree to back-charges for having the corrective work performed by another contractor.

Termination for cause will not be an issue when a project runs smoothly, the lines of communication and cooperation between the owner and the contractor remain open and productive, and the project work is satisfactory and on schedule and on budget. So it is safe to say that by the time an owner is considering termination it has probably witnessed serious and troubling actions or inactions that cause the owner to conclude the contractor cannot or will not be able to pull the project over the finish line. And by the time a public owner seeks advice from legal counsel the project file is usually full of letters and emails between the parties that describe...
the nature and duration of the problems encountered and the efforts by both parties to deal with them. If the relationship between the owner and the contractor is not so utterly soured that they are still talking to each other, the owner has probably expended quite a bit of time encouraging the contractor to continue and is willing to accept any evidence, no matter how trivial, of an interest and willingness on the part of the contractor to complete the project.

Public owners work with contractors of all types and sizes on projects of all types and sizes. These owners do so under statutes, policies and procedures adopted by states legislatures and the elected officials on the owner’s corporate boards and councils. Staff performing project management are expected to assist contractors to succeed and successfully complete these projects. Because staff will have to explain the nature and extent of a failing project to their boards or councils, as well as the estimated costs in terms of time and dollars to complete it with a replacement contractor, and the risk associated with a challenge to a termination action, it is also in the public owner’s best interest to exhaust all reasonable efforts to salvage the project with the original contractor.

One option is to take advantage of the dispute resolution provisions at an early stage. NCGS §143-128(f1) requires mediation as a condition precedent to any litigation on a public building project. The successes resulting from that action have prompted some public owners to incorporate a pre-litigation dispute resolution provision into all of its construction contracts. Owners may also want to consider including contract language that provides for a “Good Faith Meeting” to discuss disputes before the formal mediation process can be invoked. Even if the owner is not a party to the dispute, the owner can also help facilitate the process and the parties’ communications. And, even if the contract is silent on the dispute resolution process, nothing
prohibits any party from suggesting or requesting voluntary mediation. If mediation can prevent a termination for cause, that will benefit all parties.

Another option is to request a meeting with the surety. Regardless of whether a conference is required by the performance bond or simply an option, a meeting can be a good place to remind the surety that it has some skin in the game and should be interested in the successful completion of the project.

CONSIDERATION OF OTHER CONTRACT PROVISIONS THAT MAY AFFECT RIGHTS AND REMEDIES IN ADDITION TO TERMINATION

An owner considering termination of a contractor for cause needs to review its entire contract to determine whether other provisions offer a remedy or some relief that will enable it to avoid termination, or to at least weather a rough patch in the project. The review also will be helpful because it will enable an owner to identify terms of its contract that may potentially be in conflict with each other and provide fertile ground for disputes and litigation.

One example of a contract clause that would be useful to avoid or delay termination is a “right to supplement” clause. Particularly in a situation where progress has been delayed and pressures to meet the scheduled completion date are mounting, a right to supplement clause allows the owner to utilize a less drastic remedy than termination. The owner may not avoid a dispute with the contractor about the amount of back-charges to cover the cost of supplemental workers, but it avoids the delays, cost overruns and the broken relationship that occur with a termination for default. And even if the relief is temporary and termination ultimately becomes necessary, a court reviewing the owner’s act of termination will look favorably upon its attempt to first use the less drastic remedy.

Another contract clause that is recommended if the contract includes a termination for cause provision is a termination for convenience clause. This provision allows the owner to
terminate without cause and without having to justify the termination decision. Depending on the nature and timing of the default, and how contentious the relationship has become between the owner and the contractor, an owner may conclude the benefits of simply being done with the contractor outweigh the perceived benefits of a default termination. A detailed description of the eligible costs to which a terminated contractor will be entitled when the termination for convenience right is exercised will not only help to manage the parties’ expectations in that event, but also reduce the risk of a dispute related to final closeout. The owner may be obligated to pay for work performed and perhaps some costs associated with the contractor’s need to terminate subcontracts or supply agreements, but the owner could be relieved of any obligation to pay lost profits on work not yet performed.

When a contract contains a termination clause for both cause and convenience, a good termination for convenience clause will limit the terminated contractor to much less than the contractor would be entitled to if the termination for default is later found to have been unjustified. A good termination for cause provision will state that if a termination for default is determined to be unjustified, the termination will be treated and paid for as if it had been a termination for convenience. This simple statement can significantly minimize the financial risks to the owner of a wrongful termination since the parties agreed upon the appropriate costs before a breakup occurred when everything looked rosy.

Of course, inclusion of contract clauses for both a termination for cause and for convenience will not relieve the owner of the task of evaluating which one is appropriate under the circumstances, and will not prevent a dispute over whether the initial decision to terminate for cause was justified. Owners do and should struggle with this decision. For an example of the government owner’s mindset, see, *McDonnell Douglas Corp. v. U.S.* 182 F.3d 1319, (Fed.
Cir. 1999), supra, where Admiral Morris explained why he concluded a termination for convenience was inappropriate as follows:

Because I felt very strongly that as a result of the contractors’ default, it would be nothing short of unconscionable for me to put the burden of the contractors’ failure to make progress and the contractors’ failure to fabricate parts, so as to endanger performance of the contract, put that burden on the government and the taxpayer to reimburse all costs to and to pay the contractors a profit for their failures. Id. at 1328.

In some instances, depending upon the nature and timing of the alleged default, other contract provisions may appear to provide the sole remedy for the default. An example of this potential situation would be where the contract includes a completion date for the entire project, but also includes scheduled completion dates for milestones within the project. If specific and separate liquidated damages are stipulated for failure to meet any of the milestones, review the contract closely to analyze whether there is an argument that the owner’s remedy is limited to the assessment of the liquidated damages. Of course, the analysis will be different if the owner is considering the contractor’s failure to meet several milestones, rather than just one or perhaps two and, at some point, if the contractor has failed to meet several progress points the owner may not believe the contractor can recover and meet the final completion date. Unless the contract language states the magic number of missed milestones that will be considered a default for breach of a material term, an owner contemplating terminating a contractor for cause for missing a milestone should expect that the outcome will depend upon the totality of the facts and circumstances.

Perhaps the contract terms most susceptible to potential conflict with other contract terms are those found in the performance bond. Not all performance bonds are created equal. An owner contemplating contractor termination needs to review the bond carefully not only to ensure compliance with the procedural requirements, but also to determine the substantive rights
and obligations of the surety. Some bonds require completion of the project, some may only require indemnification. In a potential termination for cause situation, the performance bond needs to be analyzed just as carefully as the construction contract. Questions to answer include, at a minimum, the following: Who gets to make the election of remedies and how much time do they have to make the election? Does the bond incorporate the construction contract and provide that the terms of the contract are controlling? Does the bond limit the surety’s liability with respect to certain types of damages? Will the owner be entitled to recover costs in excess of the bond/contract amount, such as delay costs, liquidated damages, attorney’s fees, in addition to the costs of a replacement contractor? The answers to these questions may compel a different course of action.

**CONSIDERATION OF CONTRACTOR DEFENSES**

A contractor threatened with an owner’s termination for default faces severe negative consequences for both the short term and the long term and owners should expect the termination to be vigorously contested. When the reputation and survival of the company is at stake, the contractor is incented to fight the termination with every available asset. Another portion of this program is focused on the defenses available to contractors to prevent or overturn a termination, but identification of some of the more common challenges is warranted.

**Lack of Notice and Opportunity to Cure.** Most contract termination provisions include a requirement that the owner provide the contractor with notice of the alleged default. As seen in the sample termination clauses examined previously, the time period for the notice requirement varies from contract to contract, but it is essentially a provision that allows the contractor time to cure the default that is said to be the basis for the termination. Issues of fact may arise as to whether the contractor was prejudiced by a lack of notice, but an owner’s failure to issue the
required notice prior to termination may provide the contractor with a defense to the owner’s termination.

Waiver. Subject to the legal elements of waiver, an owner may be found to have waived its grounds to terminate a contractor by evidence of its own conduct. Examples of facts that may provide a basis for a contractor to assert waiver as an affirmative defense include the owner’s acceptance of a revised schedule with an extended completion date, or allowing the contractor to perform repair work to address work that has been identified as defective. A contractor asserting waiver as a defense has the burden of proof to show that the owner intentionally relinquished its right to terminate, and contract language may make this hurdle harder to clear. (See AIA A201 § 13.4.2) This defense will be fact specific and unambiguous evidence of the owner’s conduct, actions or inaction will be required in order for the contractor to prevail.

Substantial Completion. A contractor who has brought a project to or near substantial completion may contest a termination for cause on the grounds that it has substantially performed. The argument is that the owner essentially has the benefit of what it bargained for and the time to remove the contractor has passed. Whether a project is substantially complete is a question of fact, and even if answered in the contractor’s favor this defense does not negate the contractor’s obligation to fully complete the project or to correct defective work. But if the contractor can establish that the project can be used as intended, it may simply be too late to terminate and the owner needs to look for remedies other than termination, such as breach of contract and specific performance, to address such issues as unacceptable aspects of the work. See, Restatement (Second), Contracts, § 235 (duty is discharged when it is fully performed) and § 237 (contractor has a claim for the unpaid balance and the owner has a claim only for damages if there has been substantial although not full performance.)
Owner’s Interference, Obstruction and Prior Breach. Just as a contractor may assert that an owner’s interference caused or contributed to delays on the project and entitle the contractor to additional time, it may contend that the owner’s interference precludes it from terminating the contractor for late completion. Contracts typically place the responsibility for the means and methods of performing the contract work on the contractor, so challenging a termination on the basis of owner interference, control or hindrance will be fact specific.

Owner’s Failure to Provide Architect’s Certificate of Good Cause for Termination. As discussed above, owners using the AIA contract forms are required to have the architect certify that cause exists to terminate the contractor for cause. This requirement is a condition precedent to termination and the termination can be found to be defective in the absence of the certificate. See, Town of Plainfield v. Paden Engineering Co., Inc., 943 N.E.2d 904 (2011).

CONCLUSION

Terminating a contract for cause is the ultimate break up, and, as the title of this program aptly declares, “Breaking Up Is Hard to Do!” For those of us who have to decide or advise a course of action when a construction project goes awry, there may be doubt and uncertainty as to whether the breach was material when we are judging whether to cancel the contract. We have to consider and decide whether termination is justified as a response to a breach, or whether the termination will bring down liability on our heads. Even when parties have attempted to allocate the risks of a breach, a default and the available remedies, including termination, the court will be the only party with the benefit of hindsight as it judges whether the action was justified. That is a tough vantage point for everyone, except the court, and the best bet is to try and avoid that scenario. But if that is not possible, we have attempted to provide you with some insight on where to expect the battle scenes to play out. Good luck.