TERMINATIONS OF CONSTRUCTION CONTRACTS – SUPPLEMENTATIONS-BACKCHARGES

Thomas N. Frisby

1. DEFAULT TERMINATIONS

A lot of people really like terminations of construction contracts. Maybe, for instance, construction lawyers, claims consultants and perhaps contractors with a death wish. Not so much for others. For as the eminent counselor Overton Currie once told me, a termination for default is like a death knell to a contractor, as it may destroy bonding capacity and the opportunity to bid other work, both government and commercial. When a contractor has been terminated for default, it must list this factor on future pre-qualification applications; potential customers and financial institutions, such as the surety, tend to avoid contractors with this experience. So, contractors who wish to stay in business should do all within their power to ***avoid*** the financial cost and the reputation damage of a default termination. And the threat to their very survival. And those who are about to default another's contract, be very careful as the courts do not favor terminations for default and look at them with a very jaundiced eye.

If your company has never used a really good construction attorney and claims consultant, the time to do so is when facing the possibility of a default termination! And by "good" is meant professionals who have "been there, done that" – that is, experienced in default terminations. It can be a tricky business and a contractor should not engage a professional team which will be learning on its dime. This is not the time to train your lawyer or your consultant. That is the only advice I want to give you in this article: In the event of a Cure Notice or a Termination, DO NOT GO IT ALONE. Get the advice of an excellent construction attorney.

The following is a procedure for a Federal Construction Contract; the federal and the AIA clauses are fairly similar and set forth at the end of this article, but do not go it alone. The federal clauses are mandatory and found in FAR 52.249-10 for fixed price construction contracts. These clauses must be inserted in federal construction contracts. On the other hand, in commercial or the private sector, owners and their attorneys have a great deal of discretion as to the language, time limits for notifications and cures, and damages (See Article .

Note that the government or owner may terminate a contract in whole or in part. Once again, engage an experienced professional if facing a Termination for Default (TFD), or if you are considering a termination of a contractor or subcontractor.

The Termination for Default Procedure

1. The defaulting party – the Owner -must determine if it has a contractual and factual basis for putting the contractor in default. (***Note again, the following are general concepts regarding default terminations which are pretty consistent in federal, state and private contracting, but are not necessarily identical. Each contract must be examined for its specific requirements). There is a two step approach.)***

a. **Step One** is to provide the contractor with a **"cure notice**" (the contract will specify how many days in advance of an actual termination notice.) The purpose of the cure notice is to give the contractor advance notice that it may be terminated unless it cures the default(s) or breach(es) set forth in the cure notice. It is very important for the Owner to truly delineate the reasons for the cure notice and what the basis of the contractor's default and what must be done to correct the default to enable the contractor to be capable of curing or correcting the deficiency. The basis of the cure can be:

i. Failure to meet contractual quality standards (**workmanship** requirements)

1. PREVENTING A CURE NOTICE DUE TO WORKMANSHIP. First, the contractor should avoid a concept of "inspect and correct" which is the old way of doing work for many. Under that scenario, the contractor rushed through the job and at the end had a punch list that would choke a mule. Today, we have in play a concept termed "**built in quality**" and broken down into the stage of P-I-F, or Preparatory-

Interim-Final. Following that process should assure for the most part that disputes regarding workmanship do not arise. Further, in many instances, the installation is considered faulty because manufacturer's instructions were not followed. So, it is imperative that the field supervision has a copy of the manufacturer's submittals, has reviewed them and complies with them. Third, if there are any ambiguities regarding the specification requirements or acceptance standards, clarify in writing prior to the installation. The Owner has a duty of clarification in these circumstances. If there is a dispute as to the requirements, obtain a direction from the Owner and comply with the direction.

ii. Failure to **make progress** of such a degree as to endanger meeting the contractual schedule

1. If the contract is behind schedule (for example, in negative float), the contractor has already breached the contractual schedule obligation.
2. If the contractor is not yet behind schedule, but it is very obvious that it cannot meet the schedule, this is termed "**anticipatory repudiation**" and is a basis for a cure notice and subsequent termination for default. In other words, it may be that the contractor has not yet missed a milestone of the completion date, but if it is reasonable to predict that he will so, then it is appropriate to issue a cure and if not corrected, a TFD. For example, the milestone date for "conditioned air" is two months from now but the roof is not framed and the submittals for the AHUs have not been made; it is pretty obvious that meeting this date is next to impossible. It would be appropriate to issue a cure and perhaps TFD even though the milestone date is a few months away.

3. PREVENTING A CURE NOTICE!
    a. Read the contract. Know and document delays which are excusable under the contract.
    b. Give timely written notice of justifiable delays and excuses for non-performance. The Owner may be reasonable in giving a cure notice or terminating if you have been delayed due to an excusable cause under the contract but for which no notification has been given in writing or through a schedule update.
    c. Update schedule to show impact of interferences such as changes, weather, differing site conditions. Support with field documentation.
    d. And for example, let's say the contractor provided a resourced schedule showing a 25 person crew loading at a given point in the schedule. The government sends a cure notice because your certified payroll indicates only 15 people on the job. But the reason for only 15 men on the job is that the AHU has been delayed due to a change by the Owner and there is not a need for that many resources. However, if the contractor has not provided notice of the delay, the reasons for the present resourcing, the Owner may very well be within its reasonable discretion of issuing a cure and possibly a termination for default later on.
    e. Maintain adequate resources to maintain progress and assure that your subcontractors do as well.
    f. Use planning meetings to discuss issues which are affecting your performance, provide reasons for delays and document those meetings. The contractor should object in

writing to meeting minutes which do not accurately what was discussed in those meetings.

g. And get on those punch lists, for it may be that the contract can be terminated for default when the contractor is taking an unreasonable period of time to complete the punch lists or is digging in its heels and refusing to do them!

h. The point is: the name of the game is for the contractor to perform consistently with the contract, to document that it has done so, and to protect itself by providing timely written notice of events which are impeding its progress which are beyond its control and classified as excusable under the contract. If the contractor fails to do this, it may very well face a TFD for failing to make progress.

i. Be forthright with your surety agent and your banker: let them know of potential issues on the project. Definitely do not want them to be surprised if a termination for notice is issued without any forewarning at all.

4. Responding to a Cure Notice

   a. Evaluate it objectively. If it is vague, request more specific details. If you believe it is not justified, quickly put together your response and not only transmit it in writing, but have a meeting with the party who placed you in default and discuss the issues objectively. This is normally a meeting that might be attended by your surety representative and your attorney as well. The tone of the meeting should be an honest and objective understanding of the issues by both parties

who intend to act responsibly based on the discussions.

b. Develop an action plan to respond to the cure. Discuss the action plan with the party issuing the cure.
c. Make sure you have the resources to meet your plan. Nothing is worse than being given a cure, then providing a plan to overcome the deficiencies or progress issues, and then falling on your face and not meeting your own plan.

iii. **Any Breach of Contract** which is considered material.

1. For example, if the contractor refuses to comply with a directive which the it considers to be out of scope, or to correct work it considers in contract compliance, it can still be placed in default as it has an obligation to comply with such directives.
    a. How to Prevent a Cure Notice. First, let's go back to the basics. Comply with the contract. The Owner has the right to direct the contractor to perform disputed work even if it believes reasonably that the work is out of scope of the contract. And the Owner has the right to direct that work it feels is defective be corrected, even if the contractor reasonably disagrees. In such contracts, the contractor has "signed up" to this process and the failure to comply is a breach of contract. In both instances, the contractor has a remedy of protesting all the way to the Court of Claims om the federal sector, or litigation or arbitration in the private sector, and if its position is correct, it will be reimbursed for the extra cost. If you have presented in writing

your position as to the directive , had a meeting to discuss it and the direction is not withdrawn, do not be bull headed: comply with such directives.

b. **Step Two.** If the contractor fails to "cure" the defect or make adequate progress, at the end of the specified period the Government may then issue a Termination Notice to the contractor. Remember, the Owner , through the issuance of a "Cure" Notice, is providing the contractor with the opportunity to prevent a TFD if it will just overcome (or at least develop a credible plan for so doing) the deficiencies spelled out in the Cure Notice. Contractors must take cure notices very seriously and not just become enraged, blame the owner for not knowing what it is doing, and go their merry way. Yet this is too often what occurs.

c. Burden of Proof. The Government has the burden of proving that its cure and termination actions were justified. It must demonstrate that the factual situation supports the contractual right to terminate, and it should have the burden or proving that the contractor's default was not excusable. When you check the Owner records (either through voluntary, FOIA if the government, or discovery), there should be a Memorandum setting forth the contractual and factual basis of the termination. Often, even if this does exist, if may be very anemic and provide the contractor a basis of defense, so it is a vital document for the contractor to obtain. If your contract has been terminated, then, GET A COPY OF THAT TERMINATION MEMORADUM!

d. Defenses to a Termination for Default. The Owner's right to terminate a contractor must be exercised with reasonable discretion. And remember that the courts disfavor TFDs, so if a cure notice is received and it is justified, the contractor will do well to put together a very reasonable plan to cure the default and then work like the dickens to do so. If the contractor is "ready, capable and willing to perform the work in a timely manner" and has so informed the Owner , this factor will weigh very heavily in favor of the contractor and against a finding of

TFD. The following is at best a scratch the surface of the knowledge a contractor should have about these things . . .so see a good construction attorney.

i. The factual and contractual basis of the TFD must be demonstrated accurately in the Owner's Memorandum of Termination. If the factual basis of the TFD is inaccurate or unsupported, the TFD will likely fail.

ii. If there are contractual excuses for non-performance or delays in progress, the Owner is not entitled to terminate the contractor for default. The federal government excuses are listed in FAR and include:

1. Change Orders including constructive changes affecting progress
2. Differing Site Conditions
3. Unforeseeable weathers and strikes
4. Fires and floods
5. Delays by subcontractors if those delays are also excusable under the contract.
6. Impossibility of performance if the impossibility is not caused by the contractor. Remember, because a task is difficult or simply more expensive to perform than the contractor had anticipated, this does not constitute impossibility. The contractor should have taken these factors into consideration when it bid the project.
7. Delays caused by over inspection (as long as the contractor complies with any directive by the Owner to correct or remediate.)
8. Really, any other unreasonable delay by the Owner whether in approving submittals, inspections, payment. The rub is that the contractor must be on top of these issues, properly document and provide adequate and timely notice.

9. The contractor's breach is minor or the project is about complete and the contractor is a bit behind, but is working diligently toward completion.
10. WAIVER. This defense assumes the Owner has not objected to the contractor's lack of progress or workmanship deficiencies previously. It is a complicated defense and not a slam dunk. If the Owner has not objected to schedule delays previously, for example, it can issue a new completion schedule and direct the contractor to meet that schedule and failure to do so may be a breach. (Note, a TFD issued by the Owner after the original schedule has been missed, assuming no notices to cure previously, would be considered improper.) If the Owner has failed to object previously to improper workmanship, it can direct that the work be corrected and follow the termination procedures if the contractor fails to comply.

iii. If it is found that the TFD is **wrongful**, under federal procedures, **it will be automatically converted to a TFC**, or termination for convenience, to be discussed later in this article.(This may not be the case in private contracts, even if there is a TFC clause, if the Default clause does not have a specific "automatic conversion" provision).**This is very important**: if a termination for default is found to be wrongful in common law , the defaulted party would be entitled to consequential damages (loss of profit and a whole bunch of stuff) But in the federal termination for default termination clause, when the default termination is determined to be wrongful, it is automatically converted to a termination for convenience and the contractor is limited to certain demobilization charges and profit on work performed up to the Termination. And no consequential damages. Please note: as stated, in the commercial world,

not all construction contracts contain Termination for Convenience clauses; and not all commercial contracts which do have TFC clauses are automatically so converted in the event a TFD is wrongful. Again, a tad confusing and ambiguous and the reason to have an experienced construction contract lawyer at your side.

iv. The party issuing the cure and subsequently a TFD must really check and double check its position, because if the TFD is wrongful, the cost to the defaulting party can be significant. For example, in a case in South Carolina, the Navy terminated a contractor for default for issues of workmanship which the contractor claimed were really design problems. The government had withheld over $1 million from the contractor due to these issues and potential Liquidated Damages and when the contractor was about 50% completed, issued a Cure Notice. After meetings with the Navy to explain the contractor's position and to present a recovery plan, the Navy nevertheless terminated the contractor for default. Subsequently, the Navy reprocured the incomplete work at an increased cost of around $5 million. Unfortunately for the Navy and the taxpayers, the government lawyer at the Court of Claims agreed with the contractor's position and caused the TFD to be converted to a Termination for Convenience. A high profile project needed during the war in Iraq costs another five million dollars and was delayed another half year or so because the Navy had been more determined to issued a TFD than to do its homework to determine if it was truly justified. The contractor was reimbursed its total actual cost plus profit thereon, up to the time of termination, and all demobilization and settlement preparation costs. The moral of the story: TFDs are complex and can be very costly to both parties so it is important that facts and not emotions govern the action of the parties.

2. The Procedure After a TFD is issued.
    a. First, a TFD is just that: the contract is no more.
    b. Second, the Owner has the right to reprocure, that is, to get some other entity to finish the work (Actually the Owner in some situations can complete the work itself with its own resources). However, this right has its limitations:
        i. First, the Owner must give written notice of the TFD to the contractor's surety. The surety may decide it is in its best interest to take over the work and to thereby, hopefully, mitigate its own damages because this course of action may result in lower reprocurement costs than if the Owner obtains another contractor to complete the work (Note: the excess costs of reprocured work is always a multiple, at least a 1.5 multiple, of what it would have cost the original contractor to have performed) . The surety does not have an obligation to take over the work and the Owner does not have a duty to allow the surety to do so. If the surety's take over plan is reasonable, and it is in most situations, the government will provide its assent. It is important to realize that a surety stands in the shoes of its principal, the contractor. It has the same defenses at the contractor would have had as well, and so it is very important to keep the surety briefed throughout the process so it can make a well informed decision regarding actions that it should take. And because sureties have been through TFDs so often, obtaining advice and input from the surety representative just makes a lot of sense.
        ii. Second, assuming the surety has made no offer to take over the work from the defaulted contractor and to complete it, the Owner may now reprocure the work assuming it meets these criteria:
            1. The reprocured work is the same or similar to the original contract. In other words, if the original

contract was for a Pinto, the government can't now get a Cadillac. It doesn't have to be an identical Pinto, but pretty close.

2. The Owner must have actually incurred costs of excess reprocurement. The Owner has to show the contract, invoices and evidence of payment.
3. And most important, the government Owner must demonstrate that it "acted responsibly to minimize the excess costs resulting from the contractor's default." In other words, the Owner must mitigate the damages it seeks from the contractor. But if the Owner takes an excessive amount of time to reprocure and that fact results in higher reprocurement costs for whatever reasons, the contractor may not be liable for disproportionately higher damages than had it reprocured within a reasonable period of time.

iii. Excess costs of reprocurement and Liquidated Damages. So if the Owner's TFD is reasonable and follows the required procedures, it will be entitled to collect from the contractor or perhaps eventually the contractor's surety, reasonably incurred excess costs of reprocurement, **and liquidated damages.** And those LDs continue to run through the period it takes to advertise for and award a successor contractor, and the time it takes to perform the work. Of course, if there are delays in the work by the successor contractor caused by its own performance or by the Owner, the contractor will not be responsible for the LDs for these delays.

iv. Contractor's monitoring of the performance of the successor contractor. Because the successor contractor may be performing work that is different than the original contract, or changes to improve the design, or taking longer to perform the work because of its delays or those of the Owner , the defaulted contractor and its legal team must

monitor the entire reprocurement process. In part, this may be done through discovery/FOIA documents and sometimes the Owner will permit periodic inspections by the contractor's representative. Not always but it is worth a try.

TERMINATION FOR CONVENIENCE

There are two circumstances under which the Termination for Convenience Clause kicks in. First, as indicated above, when a TFD is determined to be wrongful, in federal construction contracts, the TFD is automatically converted to a Termination for Convenience. And by operation of law, the TFC clause is included in the contract even if for some reason the Contracting Officer failed to include it.

The second circumstance for the implementation of the TFC is when the need for the procurement no longer exists. In this situation, the government issues a TFC and the right of the contractor to proceed is terminated. The recourse of the contractor is slim to meager; it is entitled to demobilization costs and profit on work that has been performed. This latter issue can provoke quite a dispute as well, for issues of overbilling may raise their ugly head. In addition, the contractor may lose money on early operations of an activity and then through its learning curve eventually is able to produce at a lower cost that is consistent with its unit price for the work. How much is the contractor entitled to collect in profit on work performed before the contract was terminated for convenience.

After the TFC the contractor should quickly prepare its settlement claim, which may include:

1. Settlement with subcontractors and suppliers
2. Storage and transportation costs
3. Cost associated with the settlement proposal
4. Other costs directly associated with the TFC

The contractor's cost will be audited by the government (DCAA) in accordance with Section 31 of FAR or the applicable audit provisions in state and private contracts. In effect, the concept of a TFC is a conversion from a fixed price contract to a cost plus arrangement. It is highly recommended that the contractor really prepare for this audit, and have laid out all the cost related documents necessary to support is settlement proposal. We call this a "desk top audit" with summaries of cost categories (such as labor, material, subcontracts, et al) followed by the accounting and field documentation documents which support

these summaries. So for a given subcontractor, you would have the subcontract agreement with change orders, payment requests to the subcontractor together with pay requests affecting its work, evidence of approval of the pay requests, evidence of payment to the subcontractor and so on. On labor accounts, the spread sheet, backed up with time sheets, certified payrolls, cancelled checks, union and other benefit payments, et al. All of the supporting documentation is available in a very organized manner for the auditor to verify.

And don't be surprised if the auditor questions "factor"; for example, a contractor's accounting system may show small tools as a factor of labor. Be prepared for that cost element to be attacked by the auditor. If the project manager is carried in home office overhead (G&A) and not as a direct cost on the project, again this may be questioned by the government. It would be helpful for the project manager to "time card" his time to each specific project if he is handling more than one. Initially, the Owner wants to see that the cost in the settlement proposal was reasonably incurred in response to a contractual requirement (so what if you have done extra work without protest?), that it was reasonably incurred, there is evidence of payment and that it is a real cost and not a "factor". It will buy off on estimates but you are much better on using actual auditable costs.

Your attorney or consultant will guide you through some of the Owner's attempts to reduce the amount it owes. For example, it may argue that it has overpaid for work, that some of the work was defective and is entitled to a credit. For the most part the Owner loses this argument. But the Owner may argue that the contractor's bid was too low and it is going to make up losses by being reimbursed for actual costs. The Owner may win on this one but the odds are in the contractor's favor. The Owner may argue that the contractor's costs are unreasonable, and to the extent that it can provide evidence that this is the case, the Owner may win on this one.

This section has to do primarily with the federal government process but the principles are pretty well the same in all sectors, as indicated. However, the termination for convenience clause is being used extensively in the private sector as well. In the private sectors, lawyers may customize these clauses which may contain unique provisions. (For example, a contractor on a private construction

project may be 30% or so completed and the owner terminates for convenience and awards the balance to another contractor which it feels will perform more diligently and timely, or the contractor is threatening with a large acceleration claim because of early problems caused by differing site conditions. This gives the owner the right to terminate the contract, pay for actual costs up to the termination and a reasonable profit, and then have a successor contractor come in and complete the project.) So the foregoing may not apply at all to a given private sector contract and therefore it is imperative to fully understand the TFC clause prior to entering into the contract, and if it is invoked, for your attorney to analyze it and the process which must be followed.

THE CONTRACTOR'S RIGHT TO ABANDON OR TERMINATE ITS CONTRACT

Termination is a sword which can cut both ways. Circumstances may exist which give the contractor the right to terminate or to abandon it either without financial liability and/or the ability to collect damages due to those circumstances.

"Those circumstances" by definition must amount to a material breach of contract. The contractor must demonstrate that the party being terminated had a duty, that the duty was material, that notice to cure was provided and the breach continued.

The contract itself may provide for such an abandonment, such as the payment clause or certain suspensions described in Article 14.1 of AIA 201. Or a state statute regarding payment may provide for such recourse. Of course, the contractor must show that there was not a reasonable basis for withholding payment.

A cardinal change which is described in the article on Changes is by definition a breach of contract. A cardinal change may be a major change to the design which could not have been contemplated by the parties, or it could be the result of multiplicity of changes of such a magnitude that the basic character of the means and methods of performing the work has changed dramatically. In a recent claim involving a government facility, the general contractor stopped issuing schedule updates half way through the project, changed the sequence of not only the various structures (there were six or seven different buildings) but also the sequence within each structure, all of which would result in a year prolongation of the project. The claim was negotiated and did not go to court, but the basis of the negotiation was a "cardinal change".

It is rare that a contractor should walk away from a project. To do so takes undisputed circumstances, an excellent construction attorney and a lot of guts. So, the contractor may be entitled to claim a breach, but instead of walking away from the job, it might be most prudent to provide notice, continue working under protest, and settle out in a mediation thereafter. If you have a very good factual case, the odds are that you will be successful in an alternative dispute resolution venue, or in court if you have to go that far. If you walk the job, you have put yourself at a disadvantage, but don't make that judgment based on what you have read here. Get advice of attorney and surety agent! For if a judge subsequently determines that your abandoning the project was wrongful, you are going to be responsible for all the damages the other party has suffered, including delay damages , excess cost of reprocurement, and the kitchen sink.

SUPPLEMENTATIONS

Many contracts contain "supplementation clauses"; that is, if the contractor or subcontractor fails to provide adequate work force, the Owner or the general contractor as the case may be will have the right, upon written notice

so many days or hours in advance, to provide additional work force to maintain the schedule. Of course, such clauses are enforceable. The problem is that often a contractor may be behind the basic schedule but that schedule has not been updated to reflect changes or delays not the responsibility of the contractor . . .and to make matters worse, the contractor has not asked for time extensions so it does appear that he is actually behind schedule. Obviously, the same tired old advice is warranted here: give timely, written notifications of delays and interferences and provide schedule updating to demonstrate where you would be on a schedule adjusted for those delays and interferences.

Normally, even if the contractor is not at fault, it is best to at least consider adding its own work force and then submitting a claim due to acceleration or the changes which caused this situation, than having the owner or general contractor to add work force. When work force from another entity is added, it is a rule of thumb that it is going to cost more than adding your own additional crew. So sometimes a business judgment is more practical than a legal judgment. One can add work force and still be protected through giving notice, justifying schedule impacts and so on.

BACKCHARGES

Excuse my French, but many a subcontractor is screwed due to unwarranted backcharges. This issue will be fully discussed in the article written for Subcontractors but suffice it to say, the subcontractor should begin the process of protection in two preliminary ways: first is to have a written policy regarding protection of the work of others and of cleaning up after its own work, and then enforcing that procedure. Second, in the subcontractor's proposal for the project, it should state that no back charge will be recognized unless there is a) timely written notice, b) there is proof that any damage or cost is due to its responsibility, and c) there is proof of damages.