Contract Termination Clauses

Part I – Termination for Fault

by Peter M. Kutil and Karl Silverberg

The last word any contractor ever wants to hear is the word "termination." Termination is an option that most owners only explore as a last resort. The consequences of termination of a contract may lead to financial ruin for the contractor and may trigger personal guarantees given by corporate owners to sureties under the surety indemnification agreements. For the owner, more delays and more costs may result from a termination, with no guarantees that these costs will ever be recovered. Because termination carries with it severe consequences Courts characterize "default termination as a 'drastic sanction' [that] 'should be imposed . . . only for good grounds and on solid evidence.' [And] the burden of proof on the issue of justification for a default termination always rests on the [owner]." (Sun Cal, Inc. v. United States, 21 Cl. Ct. 31 (Ct. Cl. 1990).)

The stage of the work may enter the owner's calculation as to whether to terminate. If the contractor (or subcontractor) is not performing in the early stages, termination may be a better option than waiting until things get even worse. The courts might ask: "If the contractor was so bad to warrant termination, why did you wait until the very end." Courts also consider the doctrine of substantial completion that states that termination is no longer a viable option when the contract is substantially completed. Every case is unique, and termination usually represents some breaking point in the relation between the parties.

This article discusses the typical contract terms and concepts regarding termination for fault and the circumstances that may lead to termination. There are two types of termination, termination for fault, sometimes called termination for cause or termination for default, and termination for convenience. A termination for fault occurs when the contractor cannot perform its work to the required standards. Termination for convenience is governed by the contract and is a way for the owner to unilaterally cancel the contract even if nothing is wrong with the contractor's performance. This article will focus on termination for fault, and termination for convenience will be reserved for a later article.

Termination for fault has two components. First is the procedural aspects governed by the contract, such as notice and a right to cure. The second is the substantive aspect, such whether a material breach has occurred.

Procedural Aspects

The federal government's Federal Acquisition Regulations (FARs) provides a typical framework for contract termination provisions. The FARs state: "[T]he contracting officer shall give the contractor written notice specifying the failure and providing a period of 10 days (or longer period as necessary) in which to cure the failure." (FAR 49.402-3 Procedure for default) The FARs require that other criteria be established and contain many exceptions and special provisions, so the above requirement is only a general description.

The American Institute of Architects, General Conditions A201-1997, contains similar requirements. Section 14.2.2 states that: "[T]he Owner, upon certification by the Architect that sufficient cause exists to justify such action, may . . . after giving the Contractor and Contractor's surety, if any, seven days' written notice, terminate the employment of the Contractor."

The General Condition prepared by the Engineers Joint Contract Documents Committee ("EJCDC"), provides that the owner must give "the Contractor (and Surety) seven days written notice of its intent to terminate the services of Contractor." And states further: "Contractor's services will not be terminated 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."

If the owner has failed to follow the termination procedure such as notice, cure and certification as applicable, a terminated contractor may be entitled to recover damages for wrongful termination.

Substantive Aspects

To justify a termination for fault, a contractor must have "materially" breached the contract. This means the breach must be significant. Material breaches of the contract that lead to termination usually happen when the contractor fails to perform the work in a proper or timely manner because of lack of skill on its part, or because of financial problems.

Standard contract provisions often describe what constitutes a material breach. The FARs standard contract, provision 52.249-10, provides: "If the Contractor refuses or fails to prosecute the work or any separable part, with the diligence that will insure its completion within the time specified in this contract including any extension, or fails to complete the work within this time, the Government may . . . terminate the right to proceed with the work."

Similarly, the AIA A201-1997 General Conditions, Section 14.2.1, states, the Owner may terminate the Contract if the Contractor:

- Persistently or repeatedly refuses or fails to supply enough properly skilled workers or proper materials
- Fails to make payments to Subcontractors for materials or labor in accordance with the respective agreements between the Contractor and Subcontractor
- Persistently disregards laws, ordinances, or rules, regulations or orders of a public authority
- Otherwise guilty of substantial breach of a provision of the Contract Documents

The EJCDC General Conditions are substantially similar to the AIA requirements.

Standard of Review

Critical to understanding a contractor's rights when a termination occurs is understanding how courts review the owner's decision to terminate. The owner's decision to terminate as rendered by a contracting officer, or similar official, in many jurisdictions will only be reversed if the decision to terminate was capricious, arbitrary or clearly in error. Courts generally give deference to the contracting officer's decisions because the contracting officer is the person usually most familiar with the project. Some jurisdictions, however, make no distinction between government work contracts and private contracts and rule based on whether the contractor was in material breach of the contract and review the termination without any special weight given to the governmental officer's decision. It may also occur that the owner breaches the contract by interfering with the contractor's performance. When this occurs the contractor will have a defense to the termination.

Surety's Role

The surety is typically put to the task of having to respond to the owner's termination of a contractor for fault. While the owner and contractor can litigate the propriety of the termination for years, the surety is put to the task of responding immediately to the owner's declaration that the contractor is in default, leaving the financial consequences to be sorted out later.

Upon termination, there are four basic scenarios that can occur. First, the owner can hire a new contractor and charge the cost directly to the surety. Second, the surety can hire a new contractor directly. Third, with the owner's permission, the surety can hire the terminated contractor to complete the work. This is done with contractors that can perform the work but have financial problems that may have caused the default. Fourth, the surety can tender the penal sum of the bond. Theoretically, the surety can side with the contractor and stand on the sideline and do nothing, but this is rare and seldom seen. In the context of each of these scenarios there are also issues regarding the contractor's and its corporate owners' indemnity agreements. The surety has a contractual right to recover its losses from these indemnitors.

Conclusion

Obviously, the best thing is to avoid termination in the first place. To start, contractors need to perform quality work. Next, contractors need to develop good working relationships with the owner and the owner's consultants. This way, minor disputes that are mere mole hills do not grow out of hand and become mountains. If a contractor is experiencing financial problems, the contractor has options. In such situations, contractors should speak to the surety before performance suffers to see if a financing agreement can be arranged. Experienced sureties recognize that it will cost the surety more in the long run if a contractor is defaulted or is forced to abandon a project. Owners too might be flexible at times. For example an owner may expedite the review and payment of a claim, adjust the schedule pending the review of a claim, or modify the schedule, so that a contractor can continue performance. The bottom line is that termination is in no one's best interest and all parties should take steps to avoid its undesired results.

Peter Kutil, **Esq.**, and **Karl Silverberg, Esq.**, are attorneys with the firm of King & King, LLP in New York and focus their practice on serving the construction industry. More information is available at their Web site: www.king-king-law.com.