Contract Termination Clauses

Part II – Termination for Convenience

By Peter M. Kutil and Karl Silverberg

In its basic format, the typical termination for convenience clause in construction contracts and government contracts gives the project owner the right to unilaterally terminate the contract while at the same time limiting the project owner's damages that otherwise would be incurred. Termination for convenience has nothing to do with the contractor's performance, which is the subject of the termination for fault (or default) clause. An owner exercising the termination for convenience clause, is basically saying, "Sorry, I no longer want the item I contracted for, I will pay you your cost to date, and you go your way and I'll go my way."

The typical clauses usually provide that the contractor will be paid the cost of performance and profits up to the time of the termination for convenience, but the contractor usually does not receive any compensation for the remaining work the contractor did not perform, meaning no recovery of lost profits. As discussed below, the American Institute of Architects, a major source for standard form construction contracts, does provide for the recovery of lost profits for the remaining work not yet performed.

With respect to construction contracts, government procurement contracts and most other contracts, even without a termination clause, a party has the power (but not the right) to unilaterally terminate a contract. Such unilateral termination without justification, however, constitutes a breach of contract. Except with the sale of certain unique items, such as real estate or a unique watch or antique, a court will not force a party to perform a contract. Therefore, a party may breach the contract and/or walk away from a contract, but must pay the resulting damages. Normally, when one party breaches a contract by unjustifiably terminating the contract, the breaching party must pay the non-breaching party the lost profits that the non-breaching party would have otherwise earned had the contract not been terminated. The termination for convenience clause gives the owner/government the power to unilaterally terminate the contract with the benefit of not having to pay the contractor its lost profits on the work remaining at the time of the termination.

History of Termination for Convenience

One court described the history of the termination for convenience as follows: "The concept that the government may, under certain circumstances, terminate a contract and settle with the contractor for the part performed dates from the winding down of military procurement after the Civil War. It originated in the reasonable recognition that continuing with wartime contracts after the war was over clearly was against the public interest. Where the circumstances of the contract had changed so dramatically, the government had to have the power to halt the contractor's performance and settle." [*Torncello v. United States*, 681 F.2d 756, 764 (Ct. Cl. 1982)]

Termination for convenience clauses first appeared during World Wars I and II, as drafters of government contracts foresaw similar situations as arose after the Civil War. After World War II, termination for convenience clauses were first incorporated into peace time contracts.

When Can Termination for Convenience Be Invoked?

Can an owner or the government terminate a contractor for any reason whatsoever? What if right after a contract is award-

ed, the owner/government is approached by a new contractor that can perform the work for significantly less money? Can the owner/government terminate the contract for convenience and advertise a new bid so the less expensive contractor performs the work? What if the contracting officer is a Red Sox fan and the contractor is a Yankee fan? Can the contracting officer terminate the contract for convenience?

The answer to these questions in most jurisdictions appears to be, "no." It is a general proposition of contract law that contracts cannot be "illusory." A contract is illusory if there is no real enforceable obligation between the parties. If one party can breach the contract and walk away without any consequences, then courts deem that to be no contract at all. Courts often will infer reasonable conditions to make an otherwise illusory contract enforceable by implying conditions such as no termination for bad faith.

With respect to federal contracts, the federal case law has evolved in its analysis of the government/owner's right to exercise the clause. At one point, the pendulum swung to the extreme so that the government could terminate to get a better price. [*Colonial Metals Co. v. United States*, 204 Ct. Cl. 320 (Ct. Cl. 1974).]

The pendulum then swung back to the other extreme with the concept of "changed circumstance," so termination was only justified when a change in the project's circumstances arose. [*Torncello v. United States*, 231 Ct. Cl. 20 (Ct. Cl. 1982).] The pendulum in federal contracts cases now rests somewhere in the middle. Termination for convenience is generally allowed except when exercised in bad faith. [*Krygoski Constr. Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996).] The Federal Courts recognize the public policy that favors giving contracting officers more leeway to terminate when circumstances change so that the public's interests are best served. If, however, the project's conditions did not "materially" change so as to justify a termination for convenience, the Courts may imply bad faith. The Courts also recognize that public officials are presumed to act "conscientiously" and not in bad faith.

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Standard Contract Provisions

The federal government's Federal Acquisition Regulations (FARs) provide a typical framework for contract termination provisions. The FARs standard contract, provision 52.249-2, provides: "The Government may terminate performance of work under this contract in whole or, from time to time, in part if the Contracting Officer determines that a termination is in the Government's interest." Under the FARs, costs a contractor is entitled to receive include:

- The contract price for completed services accepted by the Government not previously paid for
- The costs incurred in the performance of the work terminated with profit, including initial costs and preparatory expenses
- The cost of settling and paying termination settlement proposals under terminated subcontracts
- Accounting, legal, clerical, and other expenses reasonably necessary for the preparation of termination settlement proposals and supporting data
- Storage, transportation, and other costs incurred, reasonably necessary for the preservation, protection, or disposition of the termination inventory.

Interestingly, the FARs provide that, "if it appears that the Contractor would have sustained a loss on the entire contract had it been completed, the Contracting Officer shall allow no profit . . . and shall reduce the settlement to reflect the indicated rate of loss."

Under the American Institute of Architecture ("AIA"), AIA 201-1997, General Conditions, Section 14.4.3, when an owner terminates a contractor for convenience, that contractor is "entitled to receive payment for work executed ... along with reasonable overhead and profit on the work not executed." This is unusual and owners using the AIA contract must be aware of the consequences of exercising the termination for convenience clause.

Under the General Conditions prepared by the Engineers Joint Contract Documents Committee ("EJCDC"), Section 15.03, a "[c]ontractor shall not be paid on account of loss of anticipated profits or revenue or other economic loss arising out of or resulting from such termination."

Some government contracts have clauses that convert a wrongful termination for default into a termination for convenience. So if a contractor is terminated for fault and it turns out that such a termination was unjustified, the owner/government still gets the benefit of limited liability by only having to pay damages by way of costs for the work performed, with profits, up to the time of the termination. Even without such a conversion clause, some courts even imply such a conversion clause into government contracts, which is known as a constructive termination for convenience.

Conclusion

Termination for convenience is usually a standard part of construction contracts. It has nothing to do with the contractor's performance, but is usually invoked when circumstances change so as to justify a new advertisement for bids or termination of the project. Generally, the termination for convenience clause limits recovery to profits and expenses for the work performed, with lost profits generally not allowed. Disputes may arise if the owner does not have a valid reason to trigger the clause or if the parties cannot agree on the price adjustment resulting from a termination for convenience.

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