

ROADMAP TO A SUCCESSFUL TERMINATION FOR DEFAULT

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One of the most difficult, and potentially costly, decisions facing a project owner or contractor is whether or not to terminate for default a contractor's or subcontractor's right to complete a construction contract. Even if the decision to terminate seems unavoidable, the steps to be taken in carrying out that termination for default present many opportunities for costly mistakes. Since the termination for default frequently has disastrous financial consequences for the terminated contractor, litigation over the termination decision often awaits the party exercising the termination right. If the termination default is found to have been "wrongful" or unjustified at the end of the day, then the party exercising the termination right may face significant damage claims—including profits lost by the terminated contractor and, perhaps, claims by the terminated contractor for "destruction of business" damages. In addition, the owner or contractor electing to terminate for default must quickly take the steps necessary to minimize the impact of the termination on the project, as well as to insure the collection of any additional costs incurred in completing the defaulted contractor's work. In today's difficult economic times, owners and contractors face these termination issues with increased frequency.

In order to assist the owner or contractor in the exercise, or decision not to exercise, termination for default rights, we suggest ten essential steps as a roadmap to the successful exercise of termination rights.

Step One: *Begin with a Properly Drafted Termination Clause*

Owners and contractors often learn of the inadequacies of contract termination clauses in the midst of a termination crisis. The time to assess the adequacy of a termination clause is prior to the contract execution. Consider, for example, the following questions which should be asked in assessing your termination clause:

- ***Does the termination clause clearly define the "material breaches" which will justify a termination for default?***

Only "material" contract breaches justify a termination for default. Courts will allow contracting parties some leeway in defining what is "material" to a particular contract—take advantage of that opportunity. If a task is especially important to your project, define its proper and timely completion as a "material" contract obligation.

- ***Is the termination notice period reasonable—neither too long nor too short?***

Even if your contract does not give the contractor or subcontractor the express right to "cure" a default, the law will read that right into the contract. The termination



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“notice” period becomes the “cure” period. If the cure period is too long, your project suffers as a result of your inability to move with sufficient speed in making a contractor change. If the cure period is too short, you run the risk that a court will subject your termination decision to more careful scrutiny. For example, if your termination clause provides the right to terminate on 24-hours notice, has the defaulted contractor been given any *real* opportunity to cure the default? If a court concludes that the cure opportunity was illusory, your termination right may be subject to judicial second-guessing.

- ***Does the termination clause speak specifically and adequately to post-termination rights and responsibilities?***

Your termination clause needs to anticipate some of the practical consequences of a termination. Who owns or has a right to the defaulted contractor’s records, materials, project information, as-built information, and warranty documents? Does the termination clause give you the right to an assignment of subcontracts and purchase orders entered into by the defaulted contractor? What can you require of the defaulted contractor’s performance bond surety? These questions must be addressed in the termination clause.

Step Two: Consider First the Supplementation of the Defaulting Contractor

Terminations for default almost always produce project delay, cost overruns, broken business relationships, lawyers and lawsuits. The risk of these adverse consequences can be lessened by your use of a right to supplement the work crews of a defaulting contractor. A good “right to supplement” clause is essential. If termination becomes necessary, your first use of the less drastic remedy of supplementation will help persuade a court or arbitration panel that you acted reasonably and explored other possibilities before exercising your termination rights.

Step Three: Touch All Termination Bases Carefully

Because the right to cancel your contract obligations to another party is such a drastic action and the consequences for the terminated party so often disastrous, courts closely scrutinize the terminating party’s exercise of termination rights. If the terminating party fails to touch all of the contract bases necessary to justify the termination, a court may find that the termination was “wrongful” and award the terminated party the value of the work performed, lost profits on any unperformed work, as well as other direct or consequential damages. As a result, in the exercise of termination rights, it is important to follow precisely each contractually required step in the termination process. Substantial compliance with the termination clause is not good enough. Take no short cuts. Do it strictly by the book. Use the word “default” as termination rights are invoked. Clearly communicate an intent to invoke the termination clause and—if a performance bond surety is involved—clearly indicate the intent to call upon the surety to perform. At the end of the termination notice period, confirm that the contract is terminated, even if a second notice is not required by the contract.

Step Four: Satisfy Any Pre-Conditions to Termination Rights

In addition to contractually required notice provisions, and either explicit or implied rights to cure a default, contracts sometimes contain other pre-conditions to the exercise of termination rights. For example, the AIA Document A201 (1997 Edition), a set of general conditions often used in construction contracts, requires that the project architect first certify that grounds exist for the exercise of a termination for default. If that requirement is ignored, or if the architect fails to provide a proper certification, then the terminated contractor will argue that the termination was premature and improper. Carefully observe any contract pre-conditions to the exercise of termination rights.

Step Five: Know When to Pull the Termination Trigger

Wise contractors and owners will do almost anything to avoid the project disruption and legal entanglements likely to follow a contract termination. And yet, there are certain times when a termination for default is the only solution to a project problem. For example, when a contractor abandons the work or is insisting on undeserved payments before continuing with the work, the decision to terminate for default is less difficult. Another “right time” to terminate for default may be when it seems very likely that the non-performing contractor is headed for bankruptcy. Although many forum construction agreements state that a contractor’s filing for bankruptcy protection is just cause for termination, such termination rights clearly are unenforceable under the law. For example, in a Chapter 11 bankruptcy, once the petition is filed, the Bankruptcy Code allows the bankruptcy trustee the option of either rejecting or affirming the pending executory contracts. Although a party desiring to exercise termination rights may be able to maneuver to shorten the timeframe for the acceptance or rejection of the construction contract by the bankruptcy trustee, the project may suffer significant delays in the interim. If a party desiring to exercise termination rights has a basis for termination, *other than* the prospect of bankruptcy by the defaulting party, then the time to exercise that termination right is prior to the filing of a bankruptcy petition.

Step Six: Record the State of the Defaulted Contractor’s Work

Many termination disputes involve arguments, not only about a party’s entitlement to exercise termination rights, but also serious questions regarding the extent of the damages flowing from the termination decision. For example, termination disputes almost always involve the following issues:

- Were reasonable steps taken in order to mitigate the termination damages?
- How reasonable are the costs to complete the terminated contractor’s work?
- How clear is it that the costs to complete reflect accurately the scope of the defaulted contractor’s work?

A key to winning the battle over the issues identified above is the ability to demonstrate the exact state of the defaulted contractor’s work at the time of termination. A

photographic and video record, as well as as-built plans, can be very useful. Immediately after the termination, make a record of the terminated contractor's work—highlighting defective work and clearly demonstrating the extent to which the work was complete or incomplete.

Step Seven: A Termination for Convenience “Safety Net” is Essential

Contracts typically contain a “termination for default” clause, but do not always contain a “termination for convenience” provision. A termination for convenience clause allows you to terminate without cause, and without having to justify the termination decision. The termination for convenience clause should contain a detailed description of the eligible costs to which a terminated contractor will be entitled when the termination for convenience right is exercised. Typically, a termination for convenience clause will obligate the terminating party to pay the terminated contractor for the work performed and perhaps some costs associated with the contractor's need to terminate subcontracts or supply agreements. A termination for convenience clause may not offer to pay the terminated contractor for lost profits on work not yet performed, and it almost always limits the terminated contractor to much less than the contractor would be entitled to if a termination for default is later found to have been “wrongful.”

A good termination for default clause will provide that, in the event it is determined that a termination for default was unjustified or wrongful, then the parties agree that the termination will be treated, and paid for, as if it had been a termination for convenience. This “safety net” for the improper exercise of a termination for default can materially minimize the financial risks of a wrongful termination.

Step Eight: Insist on Good Performance Bond Forms

Not all performance bonds are created equal. Some bonds (i.e., “completion bonds”) require that the surety for the defaulted contractor must complete the work. Other bonds (i.e., “indemnity bonds”) simply require that the surety indemnify the party exercising a termination right for all costs flowing from the contractor default. Other bond forms are woefully silent on exactly what is expected of the performance bond surety in the event of a default. Pay as much attention to the language of the performance bond as you do to the language of any significant contract. Make certain that your contractor's or subcontractor's performance bond incorporates the contract between you and the bond principal. Understand that, in some jurisdictions, the law may limit the performance bond surety's liability with respect to certain types of damages. For example, in Florida, a performance bond ordinarily will not cover delay damages, unless the bond, on its face, identifies delay damages as within the scope of the bond's protection. Expect and demand a surety bond that fully meets your needs in the event of a contractor default.

Step Nine: Take Time to Analyze the Causes of a Termination for Default

When the smoke clears and the termination crisis is over, look back at the contract termination circumstances. What led to the construction contract termination? It is likely

that the retrospection will identify more than one curable mistake along the pathway leading to contract termination. With some exceptions, this analysis almost always will point to a deficiency in a method by which contractors or subcontractors are selected as construction project partners. The warning signs are often present:

- Did the contractor have difficulty getting an acceptable bond or providing acceptable insurance coverage?
- Was the contractor's price unreasonably low?
- Had the contractor successfully completed projects of similar size and complexity?
- How does the contractor rate in an objective assessment of the "Three C's"—character, capital and capacity?

Step Ten: Consider a Termination Checklist

The potential cost and consequences of a termination for default argue strongly for great care in the exercise of the termination decision. And yet, often the decision to terminate a contractor's right to complete must be made in the midst of great project turmoil, with little time for reflection. In such circumstances, a termination checklist can be an important aid in the management of a termination crisis. The construction practice group at Troutman Sanders has crafted such a termination checklist, and those checklists are available, free of charge, upon request. The recommendations offered above, if followed, also should aid you in finding a safe pathway through the mine field of construction contract termination.