

**American Bar Association
Forum on the Construction Industry**

**SHIPWRECKED: Dealing With Construction Contract Defaults in the Real
World**

(“Cross the Sea: Navigating the Distressed Construction Project”)

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I. SKIMMING THE SURFACE: INTRODUCTION AND OVERVIEW

Serious legal consequences attend a declaration of default and subsequent termination. If the disputes lead to litigation or arbitration, a reviewing court or arbitrator will examine the events leading to the termination to determine whether the termination was justified. The terminating party runs the risk that its actions will be second-guessed to the point that the termination is deemed wrongful. The terminating party also risks significant cost overruns and may have problems with the replacement contractor. The parties may undergo financial pressure, upheaval, or even bankruptcy. The terminated party may lose its reputation, its bonding capacity, and possibly its financial viability. Default termination significantly increases the likelihood of litigation or other dispute resolution procedures, which, whether initiated during the project's performance or after the project's completion, will require substantial commitments in time and money.

In addition to the consequences to the parties, default may have various consequences to the project. Costs are likely to increase dramatically. The schedule may be delayed or acceleration required. Scopes of work must be completed. Patent or latent defects may exist.

This paper will examine the concept of a material default and the types of events that may lead to a default. It will review approaches that can be utilized to avoid a termination for default. It will also examine the standard industry contract terms concerning default and termination, required notices, and post-termination issues.

II. THE SINKING SHIP: IS THERE REALLY A DEFAULT?

Whether a party breached a contract is generally a question of law for the court, which will determine as a matter of law what the contract requires.¹ When the terms of a contract are unambiguous and the facts concerning breach or performance are undisputed or conclusively established, the trial court decides whether the facts show performance or breach.² Not every performance failure or occurrence of a default event will rise to a level warranting termination. A distinction exists between a breach of contract and a material breach. Material breach by one party may excuse the other party from any obligation to perform and generally presents a question of fact.³

The Second Restatement of Contracts provides the following considerations to determine whether a failure to render or to offer performance is material:

- (a) the extent to which the injured party will be deprived of the benefit it reasonably expected;
- (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which it will be deprived;
- (c) the extent to which the party failing to perform or to offer to perform will suffer forfeitures;
- (d) the likelihood that the party failing to perform or to offer to perform will cure its failure, taking account of all of the circumstances including any reasonable assurances; and
- (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.⁴

¹ *Meck v. Bishop Peterson & Sharp, P.C.*, 919 S.W.2d 805, 808 (Tex. Ct. App. 1996).

² *Id.*

³ *See, e.g., Mustang Pipeline Co. v. Drive Pipeline Co.*, 134 S.W.3d 195, 196 (Tex 2004).

⁴ Restatement (Second) Contracts § 241 (1981).

A. Default Events

Events that may rise to the level of a material breach vary. A discussion of some commonly occurring issues follows:

1. Failure to Perform

Work must be performed timely and in a workmanlike manner.⁵ Failure to perform may include a party's failure to complete a scope of work, untimely performance, defective execution of a scope of work, failure to complete punch list work, or failure to honor warranty obligations. An owner or general contractor's failure to provide site access also constitutes a failure to perform.

In the AIA Document A201-1997, General Conditions of the Contract for Construction ("AIA A201") the contractor warrants that

materials and equipment furnished under the contract will be of good quality and new unless otherwise required or permitted by the Contract Documents, that the Work will be free from defects not inherent in the quality required or permitted, and that the Work will conform to the requirements of the Contract Documents. Work not conforming to these requirements, including substitutions not properly approved and authorized, may be considered defective.⁶

The AIA A201 provides the architect with the authority to reject non-conforming work.⁷ Rejected work is grounds for termination if material to the contract.

The contractor's untimely completion of work may also constitute a default event. In that regard, the AIA A201 provides that the owner may terminate the contractor who

⁵ See, e.g., *Tharpe v. G.E. Moore Co.*, 174 S.E.2d 397, 399 (S.C. 1970).

⁶ AIA A201-1997, Art. 3.5.1.

⁷ AIA A201-1997, Art. 4.2.6.

“persistently or repeatedly refuses or fails to supply enough properly skilled workers or proper materials” to the project.⁸

2. Failure to Pay

Generally, the performance of work on a construction project triggers a corresponding obligation to pay.⁹ An owner, general contractor, or upper-tier subcontractor’s failure to pay amounts justly due is a breach of contract. If the contract includes a “time is of the essence” provision, the failure to make timely payments may be deemed a material breach.¹⁰ One of the reasons for progress payments is to provide the funds necessary for continued performance. A contractor or subcontractor who is unreasonably denied payment is justified in suspending performance until paid.¹¹ Professor Corbin, in his treatise on contracts, recognizes the particular circumstances attendant to a building contract:

There is a special factor to be considered in the case of a building contract, or any other contract the financing of which requires a progressive expenditure in the course of performance. In these cases, one reason for providing for installment payments as construction proceeds is to supply the funds necessary for the agreed performance; and failure to pay one or more installments is more likely to cause inconvenience and difficulty to the building contractor. Therefore, a failure to make one of the progress payments, even though the contract is not divisible into pairs of separate equivalents and the installment unpaid is only a small part of

⁸ AIA A201-1997, Art. 14.2.1.1.

⁹ A pay-if-paid provision would create an exception to this rule in jurisdictions where such provisions constitute a valid condition precedent to payment obligations. “A contractor is not liable and bound to pay a subcontractor until satisfaction of all conditions imposed by the subcontract.” *Associated Mechanical Corp., Inc. v. Martin K. Eby Constr. Co., Inc.*, 67 F. Supp. 2d 1375, 1378 (M.D. Ga. 1999), *aff’d*, 271 F.3d 1309 (11th Cir. 2001). Georgia is among the minority of jurisdictions where a pay-if-paid provision is an enforceable condition precedent to payment. *See, e.g., Jerome Distributors, Inc. v. B.L.I. Constr. Co.*, 237 S.E.2d 13, 13 (1977); *St. Paul Fire & Marine Ins. Co. v. Georgia Interstate Elec. Co.*, 370 S.E.2d 829, 830 (1988).

¹⁰ *United States ex rel. Virginia Beach Mechanical Services, Inc. v. Samco Const. Co.*, 39 F. Supp. 2d 661, 672 (E.D. Va. 1999).

¹¹ *Id.* at 96.

the whole consideration, is more likely to justify suspension of performance by the builder, or even total renunciation of further duty.¹²

The United States District Court for the Eastern District of North Carolina has stated this point thusly:

The subcontractor cannot and should not be expected to finance the project until such time that the prime contractor or the government decides to pay the amount due. If the subcontractor is ordered to perform the work or even required to do so, then the obligation in the absence of an express contract provision falls upon the parties so ordering the work to be done to pay a reasonable amount for that work within a reasonable time. To hold otherwise would cast the burden upon the subcontractor which in many cases would be impossible to carry as a subcontractor is usually smaller in size than the prime contractors.¹³

What is deemed a “reasonable time” in which payment must be made? Absent a specific contractual provision pertaining to when payment must be made, the parties are entitled to state their opinions of what constitutes a reasonable time. A reviewing court or arbitrator may consider the number of days between requisitions and payments for prior pay applications in determining what is reasonable.¹⁴

The impulse of an unpaid contractor or subcontractor may be to walk off the job. However, not every failure to pay may be sufficient to justify project abandonment. Absent specific contract provisions, the question under the common law will become whether or not the nonpayment constitutes a material breach. The contractor who guesses wrong may find itself liable for breach of contract if it leaves the job and the inevitable delay and disruption results. Delay in making payment when the amount of work performed or disputed or is being negotiated is not, standing alone, a breach of

¹² 3A Arthur L. Corbin, *Corbin on Contracts*, § 692, at 269 (1960).

¹³ *F.E. Robinson Co. of N.C., Inc. v. Alpha-Continental*, 273 F. Supp. 758, 775-76 (E.D.N.C. 1967).

¹⁴ *Manganaro Corp. v. HITT Contracting, Inc.*, 193 F. Supp. 2d 88, 96 (D. D.C. 2002).

contract.¹⁵ Rather, a breach may occur when a contractor unilaterally leaves the job site without completing its contractual duties.¹⁶ In such instances, completion costs may be assessed against the party that breached the contract.¹⁷ In essence, if the parties are engaged in a legitimate dispute about the amount due, the quality of the work performed, or another equally legitimate reason for delaying payment, project abandonment is a risky course of action.

Contractors and subcontractors are not lacking in remedies for non-payment. Under AIA A201, the contractor is authorized to terminate the contract upon the owner's failure to make payment. Before termination may occur, the following conditions must be met:

- (1) the payment must be past due (or the work stopped) for a period of thirty (30) consecutive days;
- (2) the cause of the work stoppage or non-payment must not be the fault of the contractor, a subcontractor, sub-subcontractor, or any of their agents or employees;
- (3) the lack of payment must result from either the architect's failure to issue a certificate for payment without reason, or because the owner has failed to make payment even though a certificate of payment has been issued and thirty (30) days have passed; and
- (4) If the above conditions are met, the contractor must give a written notice of its content to terminate the contract in seven days. If the owner cures within that time period, the conditions for termination are not satisfied.¹⁸

Failure to pay subcontractors and suppliers may be cause for termination of the contract.¹⁹ The owner of a private project may be exposed to liens if the owner or its contractor fails to pay subcontractors.²⁰ The AIA A201 states that the contractor:

¹⁵ *In re Fordson Eng'g Corp.*, 25 B.R. 506, 510 (Bankr. D. Mich. 1982).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ AIA A201-1197, Art. 14.

¹⁹ AIA A201-1997, Art. 14.2.1.2.

[W]arrants that upon submittal of an Application for Payment all Work for which Certificates of Payments have been previously issued and payments received from the Owner shall, to the best of the Contractor's knowledge, information and belief, be free and clear of liens, claims, security interests or encumbrances in favor of the Contractor, Subcontractors, material suppliers, or other persons or entities making a claim by reason of having provided labor, materials and equipment relating to the Work.²¹

The contract may provide for a dispute resolution process upon notice of a claim. Under the anticipated 2007 revisions to the AIA A201, claims between the owner and the contractor will be referred to an Initial Decision Maker ("IDM"). Unless otherwise specified by the parties, the architect will serve as the IDM. An initial decision is required as a condition precedent to mediation unless thirty days pass after the claim has been referred to the IDM with no decision having been rendered.

3. Failure to Administer the Construction Contract

The architect's duties under the AIA A201 include reviewing the contractor's submittals and shop drawings for conformance with the design concept.²² The architect is required to act "with such reasonable promptness as to cause no delay in the Work or in the activities of the Owner, Contractor or separate contractors . . . while allowing sufficient time in the Architect's professional judgment to permit adequate review."²³

Failure to administer the construction contract may also include the owner's or owner's representative's failure to respond to requests for information ("RFIs"). Failure to process RFIs may cause project delay. The owner or upper-tier contractors may fall short of their contract administration duties by failing to process change orders in a

²⁰ Remedies for non-payment are discussed in greater detail in Part II.J., *infra*.

²¹ AIA A201-1997, Art. 9.3.3.

²² AIA A201-1997, Art. 4.2.7.

²³ AIA A201-1997, Art. 4.2.7.

timely manner.²⁴ Failure to process change orders may cause delay or, alternatively, a contractor or subcontractor may be placed in the position of having paid for labor and materials to perform the changed work without receiving timely compensation.

4. Providing Defective Plans or Specifications

Nearly all construction contracts specify that the project must be built in accordance with the plans and specifications. The owner impliedly warrants the adequacy of the plans and specifications.²⁵ Accordingly, a contractor is not responsible for the consequences of defects in the plans and specifications, and the owner is responsible for the contractor's increased costs resulting from defective plans and specifications.²⁶ The owner warrants that the plans and specifications are accurate and that the plans and specifications, if followed, will be adequate to accomplish the purpose of the project.²⁷ However, the owner will not be responsible for latent or obvious defects or for defects that a reasonable pre-bid inspection would have disclosed.²⁸

²⁴ See, e.g., *Manganaro Corp. v. HITT Contr., Inc.*, 143 F. Supp. 2d 88, 96 (D. D.C. 2002) (contractor's failure to pay outstanding change order invoices was unreasonable and justified subcontractor's performance suspension).

²⁵ *United States v. Spearin*, 248 U.S. 132, 136 (1918).

²⁶ *Id.* (“But if the contractor is bound to build according to plans and specifications prepared by the owner, the contractor will not be responsible for consequences of defects in the plans and specifications.”).

²⁷ The *Spearin* case also held that the owner's responsibility is not overcome by site investigation clauses. *Id.* at 136-37. The contractor is not obligated to decide whether the plans and specifications are adequate. *Id.* at 137.

²⁸ *ABB Joint Venture v. United States*, 75 Fed. Cl. 414, 430 (Fed. Cl. 2007) (contractor cannot reasonably rely upon obvious defect); *Green Constr. Co. v. Kansas Power & Light Co.*, 1 F.3d 1005, 1009 (10th Cir. 1993) (reliance upon specifications unreasonable in light of contractual duty to conduct an independent investigation of subsurface conditions).

The owner's responsibility for defective specifications will depend upon whether it provided a performance specification or a design specification.²⁹ "Performance specifications set forth an objective or standard to be achieved, and the contractor is expected to exercise ingenuity in achieving that objective or standard of performance, selecting the means and assuming a corresponding responsibility for that selection."³⁰ Conversely, design specifications "describe in precise detail the materials to be employed and the manner in which the work is to be performed. The contractor has no discretion to deviate from the specifications, but is required to follow them as one would a road map."³¹ Design specifications set forth precise measurements, tolerances, materials, tests, and inspection requirements.³² A contractor will not be liable if it complied with a design specification.³³

5. Violation of Laws

It is incumbent upon the parties to a construction project to accomplish their duties without violating the law. Legal violations that may impact a construction project include a public entity's disregard of the public procurement laws, OSHA violations, the employment of illegal aliens, or violations of environmental laws. The project may be shut down or fines or criminal penalties imposed as a consequence of unlawful

²⁹ *Rhone Poulenc Rorer Pharm. v. Newman Glass Works, Inc.*, 112 F.3d 695, 701 (3d Cir. 1997) (McKee, J., dissenting).

³⁰ *Blake Constr. Co. v. United States*, 987 F.2d 743, 745 (Fed. Cir. 1993).

³¹ *Id.* at 745.

³² *Aircraft Gear Corp. v. Kanran Aerospace Corp.*, 856 F. Supp. 446, 452 (N.D. Ill. 1994), *modified*, 1994 WL 325754 (N.D. Ill. July 5, 1995).

³³ *Rhone Poulenc Rorer Pharm., Inc.*, 112 F.3d at 702 (McKee, J., dissenting).

activities.³⁴ The AIA A201 provides that the owner may terminate the contractor who “persistently disregards laws, ordinances, or rules, regulations and orders of a public authority having jurisdiction.”³⁵

6. Failure to Provide an Opportunity to Cure

The construction contract may include a provision requiring notice to the defaulting party and an opportunity to cure. These duties apply to the owner, contractors, and subcontractors. The requirement to provide notice of default and an opportunity to cure allows the defaulting party to repair its defective work, to reduce the damages, and to avoid further performance defects.³⁶ It also promotes the informal settlement of disputes. The party alleged to be in default will have the opportunity to consider whether the claimed defect is within the scope of its contractual obligations, to determine potential liability, and to take responsive action if deemed necessary.

Even when the parties have not included a cure provision in their contract, courts have imposed a duty to provide notice and an opportunity to cure before the contract may be terminated for faulty performance.³⁷ Failure to provide notice of defects and an opportunity to cure may be deemed a material breach of the contract.³⁸

³⁴ For example, the Immigration Reform & Control Act of 1986 makes it unlawful to knowingly hire individuals who are not legally authorized to work in the United States. 8 U.S.C. § 1324a(a)(1)(A). Fines range from \$250.00 to \$2,000.00 for the first violation to a maximum of \$10,000.00. 8 U.S.C. § 1324a(e)(4). Criminal penalties or injunctions may be imposed in cases involving a pattern of knowing violations. 8 U.S.C. 1324a(f).

³⁵ AIA A201-1997, Art. 14.2.1.3.

³⁶ *Pollard v. Saxe & Yolles Dev. Co.*, 525 P.2d 88, 92 (1974); *Sturdy Concrete Corp. v. Nab Constr. Corp.*, 411 N.Y.S.2d 637, 644 (1978).

³⁷ *United States ex rel. Cortolano & Barone, Inc. v. Morano Constr. Corp.*, 724 F. Supp. 88, 98 (S.D.N.Y. 1989).

³⁸ *Carter v. Krueger*, 916 S.W.2d 932, 936 (Tenn. Ct. App. 1996) (contractor entitled to damages, including net profits, as a result of owner’s failure to provide notice of default and an opportunity to cure).

As is the case with any other contract provision, a party may waive the cure provision.³⁹ A party may demonstrate waiver by showing actual knowledge or a course of conduct that would result in a waiver. For example, a subcontractor may waive a notice to cure provision by stating it has no intention of completing its contractual obligations or taking actions to that effect.⁴⁰

The AIA A201 requires the owner to provide the contractor and, if applicable, the surety, seven days' written notice prior to terminating the contract.⁴¹ For defective and nonconforming work, the contractor will then have seven days from receipt of the written notice in which to cure.⁴² Failure to provide the seven-day notice constitutes a material breach of the construction contract.⁴³

B. Waiver of Default

A party may waive its right to terminate for default if the party becomes aware of events that rise to the level of a material default yet fails to take action. "Waiver refers to the 'abdication of rights under a contract.'"⁴⁴ For example, waiver may occur by implication if a performance date passes and the contractor has not been terminated for default.⁴⁵ The elements of such a waiver are the owner's failure to terminate within a

³⁹ *Wolff & Munier, Inc. v. Whiting-Turner Contracting Co.*, 946 F.2d 1003, 1009 (2d Cir. 1991) ("The Subcontract's cure provision, like any other contractual provision, 'may be waived by implication or express intention of the party for whose benefit the provision inures.'").

⁴⁰ *Id.* at 1006-07, 1009 (subcontractor's implied threat to walk off the job, layoff of workers, manpower reduction, and increased demand for compensation in response to request for performance assurance deemed waiver of two-day cure provision).

⁴¹ AIA A201-1997, Art. 14.2.2.

⁴² AIA A201-1997, Art. 14.2.2.

⁴³ *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166, 176 (D. Mass. 2003).

⁴⁴ *Dangfeng Shen Ho v. United States*, 49 Fed. Cl. 96, 105 (Fed. Cl. 2001), *aff'd*, 30 Fed. Appx. 964 (2002).

⁴⁵ *Id.*

reasonable time after the default under circumstances indicating forbearance, reliance by the contractor on the failure to terminate, and continued performance by the contractor with the owner's knowledge and implied or express consent.⁴⁶

Termination rights may be retained by expressly indicating as much to the other party. Preservation of termination rights places a heavier burden on the party seeking to prove that the right to terminated has been waived.⁴⁷ Once a performance issue or deadline has been waived, new performance criteria must be set, either unilaterally or bilaterally. Notice and a reasonable opportunity to meet the new criteria must be provided.⁴⁸

C. Documenting the Default

Since termination greatly increases the likelihood of ensuing litigation or other dispute resolution proceedings, the events giving rise to the default should be well documented. Documentation of defective work may consist of correspondence, photographs, or videotapes depending upon the circumstances. Schedule-based defaults may be documented by progress reports, as-planned schedules, and the contractor or subcontractor's payment applications. Key witnesses should be identified, interviewed, and encouraged to memorialize their observations to aid later recall.

II. CAN THIS SHIP STAY AFLOAT? ALTERNATIVES TO TERMINATION FOR DEFAULT

Even if just cause exists for default termination, termination for default is inherently risky and should be undertaken only as a last resort. Options to avoid termination for default should be carefully considered. An owner or upper-tier contractor

⁴⁶ *Abcon Assoc., Inc. v. United States*, 44 Fed. Cl. 625, 629 (Fed. Cl. 1999).

⁴⁷ *Id.*

⁴⁸ *Id.*

should be careful to preserve and not to waive its rights if termination alternatives are undertaken. Written notification of the party's intent to preserve and not waive its right to terminate for default is recommended.

A. Termination for Convenience

If available by contract, a termination for convenience may be utilized to avoid default termination. A termination for convenience provision grants an owner or upper-tier contractor a broad right to terminate a contractor or subcontractor's performance without cause after a contract award. Termination for convenience provisions generally limit the terminated party's damages to costs plus profit on completed work and the costs of preparing the termination proposal. The terminated party may not recover breach of contract damages, anticipated profits, or other damages. However, if a termination for convenience is found to be improper, damages may be available to the terminated party.

1. Contract Provisions

The federal government's right to terminate for convenience is set forth in the Federal Acquisition Regulations System ("FAR"). Various alternate prescribed clauses are included in the FAR, depending upon the dollar value and nature of the contract. For example, the provision governing termination for convenience for a fixed-price contract over \$100,000 in value states:

(a) 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. The Contracting Officer shall terminate by delivering to the Contractor a Notice of Termination specifying the extent of termination and the effective date.⁴⁹

⁴⁹ 48 C.F.R. § 52.249-2(b).

The contractor is required to stop work upon receipt of a notice of termination. The contractor must place no further subcontracts and terminate all existing subcontracts. All right, title, and interest in the terminated subcontracts must be assigned to the federal government. The contractor must settle outstanding liabilities if approved by the contracting officer; complete performance of work not terminated; and take other actions as directed by the contracting officer.⁵⁰

The AIA A201 includes a termination for convenience provision at paragraph 14.4.1, which provides that:

The owner may, at any time, terminate the contract for the owner's convenience and without cause.⁵¹

Section 14.4.2 of the AIA A201 provides that upon termination for convenience, the contractor must cease operations as directed by the owner; take any actions necessary or that the owner may direct for the protection and preservation of the work; and, except for work directed to be performed prior to the effective date of termination, terminate all existing subcontracts and purchase orders and enter into no further subcontracts and purchase orders. Under the AIA A201, when an owner or general contractor terminates for convenience, it does not have the right to assume the subcontracts. The owner will be unable to force the subcontractors to complete their work. The subcontractors may increase their prices to complete the work, dramatically increasing the project's cost.

2. Bad Faith Termination for Convenience

The right to terminate for convenience is not absolute. Termination for an improper motive or with the intent to injure may constitute a bad faith termination for

⁵⁰ 48 C.F.R. § 52.249-2(b).

⁵¹ AIA A201-1997, Art. 14.1.1.

convenience. A bad faith termination for convenience may result in breach of contract damages.

Bad faith termination for convenience has been equated with evidence of “some specific intent to injure the plaintiff.”⁵² Courts will examine whether the termination was motivated by malice and have found bad faith when there was evidence of a “conspiracy to get rid of [the] plaintiff.” When termination is motivated by animus toward the terminated party, bad faith may be found.⁵³ In contrast, a termination for convenience simply for the purpose of saving money would not equate to a specific intent to injure the plaintiff and would not provide a basis for a finding of bad faith.⁵⁴ Absent proof of bad motive, an intentional discretionary decision that happens to result in economic disadvantage may be of no legal significance.⁵⁵

In *APJ Associates, Inc. v. North American Philips Corporation*,⁵⁶ the terminated party alleged that it was told not to worry about a contract’s termination for convenience provision because no one had ever been terminated as long as sales targets were met. The plaintiff claimed it was assured that, while the written contract came from the home office and was not negotiable, an oral agreement to the effect that the plaintiff would not be terminated for convenience was the actual agreement.⁵⁷ The court rejected these contentions based upon the contract’s merger provision, as the termination for

⁵² *Kalvar Corp. Inc. v. United States*, 542 F.2d 1298, 1302 (Ct. Cl. 1976).

⁵³ *Id.*

⁵⁴ *Capital Safety, Inc. v. New Jersey Div. of Bldgs. and Constr.*, 848 A.2d 863, 867 (N.J. Ct. App. 2004).

⁵⁵ *Id.*

⁵⁶ 317 F.3d 610 (6th Cir. 2003).

⁵⁷ *Id.* at 612-13.

convenience provision was plain on its face and therefore excluded any consideration of parol evidence.⁵⁸

B. Correct and Back Charge

The owner or upper-tier contractor may have the option to correct and back charge the under-performing party in lieu of termination. If this option is undertaken, adequate notice must be provided. Contractual provisions requiring notification of backcharges will be enforced.⁵⁹ Without proper notification, a court or arbitrator may find the back charge claim is barred.⁶⁰ If litigation ensues, the reasonableness and perhaps even the necessity of the back charge may be called into question. The scope of work should either be put out to bid or, if this is not feasible, the pricing should be reviewed in light of R.S. Means⁶¹ data or other standards to insure reasonableness.

C. Deductive Change Order

A deductive change order may be issued to delete items from the non-performing contractor or subcontractor's scope of work. Contract terms and courses of dealing relating to change orders should be observed. Clients should be counseled to obtain an executed copy of the deductive change order from the lower-tier contractor to remove any question that the work was de-scoped and the contract amount reduced.

⁵⁸ *Id.* at 614; *see also Foreman v. Milrod*, 263 A.2d 559, 562 (Md. Ct. App. 1970).

⁵⁹ *Mirra Co., Inc. v. Semass Corp.*, 2002 WL 31012226, at *2 (Mass. Ct. App. Sept. 9, 2002).

⁶⁰ *See, e.g., Sturdy Concrete Corp. v. Nab Constr. Corp.*, 452 N.Y.S.2d 252, 253 (N.Y. App. Div. 1982); *Hotel 57 LLC v. Harvard Maintenance, Inc.*, 816 N.Y.S.2d 420, 420 (N.Y. App. Div. 2006).

⁶¹ R.S. Means provides construction cost information to owners, developers, architects, engineers, contractors, subcontractors, and others in the construction industry.

D. Renegotiate the Contract

It may be possible for the parties to renegotiate the contract to alleviate the default. Scope of work items may be added or removed, means and methods may be specified, or contract terms and conditions revised.

E. Default and Allow Completion

It often happens that once a party is placed on notice of default, but prior to any termination, it will suddenly find the resources necessary to perform its obligations. The owner will pay the contractor, or the contractor will complete its scope of work in a satisfactory manner. Faced with a loss on the project, the negative repercussions of a default termination, and the involvement or possible release of a surety, the party may renew its commitment to the project. As set forth in the companion paper, the surety may elect to provide financial assistance to a defaulted contractor under certain circumstances to assist its completion of the project.⁶²

F. Withhold Payment

Frequently, an owner or upper-tier contractor may withhold payment when the work is alleged to be defective or untimely. Lien or bond claims are likely to result.⁶³

G. Schedule-Based Remedies

In lieu of default termination, the schedule may be re-worked. In some circumstances, project milestones may be adjusted without impact upon the date of substantial completion. Alternatively, the date of substantial completion may be revised if all parties agree to do so.

⁶² George J. Bachrach, *The Surety Performance Bond Lifeboat: Bailing Out and/or Salvaging Someone Else's Wreck*, Part IV.A.6.

⁶³ Payment bond claims and lien claims are discussed in Part III.J., *infra*.

H. Change of Personnel

Sometimes the personnel placed on a project are not well suited to the job. Personality conflicts may arise that disrupt the work. Individual skill sets may differ from what is necessary for the satisfactory completion of the work. A distressed project may be salvaged with a personnel change.

I. Work Force Supplementation

An underperforming party's work force may be supplemented to avoid default termination. This may be particularly useful if required permits cannot be transferred or other obstacles to default termination exist. Notice and an opportunity to cure should be provided, or an agreement to the supplementation obtained beforehand, to avoid arguments about whether the resulting back charges were necessary.

J. Remedies to Force Payment

Various remedies are available to a contractor or subcontractor to force payment. Presumably, after a contractor or subcontractor has gone without payment for a period of time, the contractor or subcontractor may be justified in declaring the other party in breach of contract and stopping work.⁶⁴ The contractor or subcontractor's remedies to enforce payment include lien rights, bond claims, stop notices, and writs of mandamus against a public entity.

1. Mechanics and Materialman's Liens

A mechanics or materialman's lien is a security interest on the owner's property in favor of unpaid parties on a nonpublic project. Claimants should be aware that, in most states, the lien laws are strictly construed against the lien claimant. As a result, the

⁶⁴ Part II.A.2., *supra*, includes a discussion of factors to be considered in assessing whether delays in payment are sufficient to justify project abandonment.

requirements of the state's lien law should be followed exactly.⁶⁵ New York is a notable exception, where the lien laws are liberally construed in favor of providing payment to laborers and materialmen who worked to improve property.⁶⁶

2. Public Project Remedies

A lien on public property is unenforceable.⁶⁷ Payment bonds are required by the Miller Act⁶⁸ for any federal construction contract; they are also required for public projects by state statutes ("Little Miller Acts").⁶⁹ Thus, the payment bond provides laborers and materialmen with a remedy on public projects that they would not otherwise have.⁷⁰ Private project common law payment bonds are also issued. The law is liberally construed in favor of the bond claimant under the Miller Act⁷¹ and under the law of various jurisdictions.⁷²

⁶⁵ For an excellent survey of state lien and bond law requirements, see Robert F. Cushman & Stephen D. Butler, *Fifty State Construction Lien and Bond Law* (2000) or Lawrence Lerner & Theodore M. Baum, *Performance Bond Manual* (2006).

⁶⁶ Compare *EMC Ironworks v. City of New York*, 742 N.Y.S. 2d 230, 232 (N.Y. App. 2002) ("[T]he Lien Law is to be liberally construed and substantial compliance with its several provisions shall be sufficient for the validity of a lien"), *aff'd*, 7 A.D.3d 366 (2004) with *Delta Fire Sprinklers Inc. v. Onebeacon Ins. Co.*, 937 So. 2d 695, 696 (Fla. Ct. App. 2006) ("A construction lien is 'purely a creature of the statute,' and because it is of this nature, persons seeking its benefits must strictly comply with the requirements of the construction lien law."), and *Cox v. First National Bank of Aitkin*, 415 N.W. 2d 385, 387 (Minn. Ct. App. 1987) ("Mechanics lien laws are strictly construed when determining whether a lien attaches, but are liberally construed once the lien is attached.").

⁶⁷ See, e.g., *DeKalb County v. J & A Pipeline Co., Inc.*, 437 S.E.2d 327, 333 (Ga. 1993).

⁶⁸ 40 U.S.C. §§ 3131-3134.

⁶⁹ See, e.g., Georgia's "Little Miller Act," O.C.G.A. §§ 13-10-1 through -2 and O.C.G.A. §§ 36-91-1 through -95 (for Georgia construction projects of \$100,000 or more).

⁷⁰ *Id.* at 330-31.

⁷¹ *U.S. ex rel. Pertun Const. Co. v. Harvesters Group, Inc.*, 918 F.2d 915, 917 (11th Cir. 1990).

⁷² See, e.g., *Sunderland v. Vertex Assoc., Inc.*, 199 Ga. App. 278, 280, 400 S.E.2d 574, 575 (1991).

The Miller Act limits bond claims to only those parties having direct contractual relations with either the bonded contractor or with a subcontractor of the bonded contractor.⁷³ State bond law rights may differ.⁷⁴

A Miller Act payment bond covers items or materials considered indispensable to the prosecution of the work. Materials considered indispensable to the prosecution of the work include water delivered to operate steam dredges,⁷⁵ lumber for concrete forms,⁷⁶ freight for materials used in the construction of the work,⁷⁷ rented earth moving equipment,⁷⁸ food supplied to labor crews,⁷⁹ transportation charges,⁸⁰ labor,⁸¹ contributions to an employee welfare fund,⁸² and architectural services for superintending the work.⁸³

⁷³ 40 U.S.C. § 3133(b); *MacEvoy Co. v. United States*, 322 U.S. 102, 110 (1944); see *United States ex rel. Water Works Supply Corp. v. George Hyman Constr. Co., et al.*, 131 F.3d 28, 35 (1st Cir. 1997) (material supplier furnishing materials under open account need not have a “formal contract”); *Home Indem. Co. v. Battey Machinery Co.*, 136 S.E.2d 193, 195 (Ga. 1964) (all persons supplying labor or material are covered, even a supplier to a third-tier subcontractor); see also *Tom Barrow Co. v. St. Paul Fire & Marine Ins. Co.*, 421 S.E.2d 85, 87 (Ga. 1992) (supplier of second-tier subcontractor may assert bond claim).

⁷⁴ For a survey of state bond law requirements, see Cushman & Butler or Lerner & Baum, *supra* note 65.

⁷⁵ *Sadler and Co. v. W.H. French Dredging and Wrecking Co.*, 52 F.2d 235, 238 (D. Del. 1931).

⁷⁶ *Turover v. Thompkins Co.*, 72 F.2d 383, 384 (D.C. Cir. 1934).

⁷⁷ *United States v. Hercules Co.*, 52 F.2d 451, 453 (5th Cir. 1931).

⁷⁸ *Carter-Schneider-Nelson, Inc. v. Campbell*, 293 F.2d 816, 818 (9th Cir. 1961).

⁷⁹ *Equitable Cas. Co. v. Helena Wholesale Grocery*, 60 F.2d 380, 382 (8th Cir. 1932).

⁸⁰ *Standard Acc. Inc. Co. v. Powell*, 302 U.S. 442, 444 (1938).

⁸¹ *American Sur. Co. v. Barrow Agee Laboratories, Inc.*, 76 F.2d 67, 68 (5th Cir. 1935).

⁸² *Sherman v. Carter*, 353 U.S. 210, 220 (1957).

⁸³ *United States ex rel. Naberhaus-Burke, Inc. v. Butt & Head, Inc.*, 535 F. Supp. 1155, 1157 (S.D. Ohio 1982).

Items not covered as labor or material under the Miller Act payment bond include bank loans,⁸⁴ boarding houses operated by contractors for profit where workers stay,⁸⁵ insurance premiums for workers' compensation,⁸⁶ and transportation charges for capital investment equipment.⁸⁷

a. Notice Requirements

Notice of the bond claim is a condition precedent under the Miller Act payment bond if the claimant is not in privity of contract with the bonded contractor.⁸⁸ Notice must be given to the bonded contractor.⁸⁹ The failure to provide proper notice is a fatal flaw to the action.⁹⁰ Notice must be given within 90 days of last furnishing labor and materials.⁹¹ Where a materials supplier furnishes materials under open account, the 90 days will begin to run from the date of the last materials furnished to the project.⁹² Remedying defective work or performing punch-list work may not extend the notice deadline.⁹³ Oral notice will not meet the statutory requirements.⁹⁴ Notice must be served by any means that provides written, third-party verification of delivery to the contractor

⁸⁴ *United States ex rel. Fidelity Nat'l Bank v. Rundle*, 107 F. 227, 228 (9th Cir. 1901).

⁸⁵ *United States ex rel. Belmont v. Mittry Bros. Constr. Co.*, 4 F. Supp. 216, 219 (S.D. Ohio 1933).

⁸⁶ *United States ex rel. Bordallo Consol., Inc. v. Markowitz Bros.*, 249 F. Supp. 610, 611 (D. Del. 1966).

⁸⁷ *United States v. Hercules Co.*, 52 F.2d 451, 452 (5th Cir. 1931).

⁸⁸ 40 U.S.C. § 3133(b)(2).

⁸⁹ 40 U.S.C. § 3133(b)(2).

⁹⁰ *General Elec. Co. v. I.H. Lewis Constr. Co.*, 375 F.2d 194, 197 (2d Cir. 1977).

⁹¹ 40 U.S.C. 3133(b)(2).

⁹² *United States ex rel. Water Works Supply Corp. v. George Hyman Constr. Co.*, 131 F.3d 28, 34 (1st Cir. 1997).

⁹³ *Southern Steel Co. v. United Pac. Inc. Co.*, 935 F.2d 1201, 1205 (11th Cir. 1991).

⁹⁴ *United States ex rel. Bros. Bldg. Supply Co. v. Old World Artisans, Inc.*, 702 F. Supp. 1561, 1566 (N.D. 1988).

at any place the contractor maintains an office, conducts business, or at the contractor's residence.

b. Suit Requirements

A lawsuit must be filed to perfect the Miller Act payment bond claim. Exclusive jurisdiction lies in the federal court in the district where the contract was to be performed.⁹⁵ Suit must be brought in the name of the United States for the use of the party suing, although the United States is not responsible for payment of any costs or expenses of the suit.⁹⁶ The suit must be filed within one year of last providing labor and materials.⁹⁷ A bankruptcy filing by the party owing the debt will not toll the statute of limitations.⁹⁸ An arbitration filing will not extend the one-year deadline, either.⁹⁹ The statute of limitations is jurisdictional in nature and cannot be waived.¹⁰⁰ Attorneys' fees are not recoverable in the absence of vexatious, bad faith conduct.¹⁰¹

From the subcontractor's perspective, it is worth observing that a pay-if-paid clause in the underlying contract may not relieve the surety of its obligation.¹⁰² It would

⁹⁵ 40 U.S.C. § 3133(b)(3)(B).

⁹⁶ 40 U.S.C. § 3133(b)(3)(A).

⁹⁷ 40 U.S.C. § 3133(b)(4).

⁹⁸ *United States ex rel. American Bank v. CIT Constr., Inc. of Texas*, 944 F.2d 253, 260 (5th Cir. 1991).

⁹⁹ *United States ex rel. Portland Constr. Co. v. Weiss Pollution Control Corp.*, 532 F.2d 1009, 1012 (5th Cir. 1976).

¹⁰⁰ *United States ex rel. Gliello v. Sovereign Constr. Co.*, 311 F. Supp. 371, 373 (D. Mass. 1970).

¹⁰¹ *F.D. Rich Co. v. United States ex rel. Industrial Lumber Co.*, 417 U.S. 116, 129 (1974).

¹⁰² *U.S. ex rel. T.M.S. Mechanical Contractors, Inc. v. Millers Mutual Fire Ins. Co. of Texas*, 942 F.2d 946, 949 n.6 (5th Cir. 1991).

defeat the purpose of a payment bond to suggest that non-payment by an owner absolves a surety of its payment obligations.¹⁰³

Generally, the surety's liability is co-equal to that of its bonded principal.¹⁰⁴ The surety may take the position that a payment bond claim is barred by a provision making final payment to the subcontractor conditioned upon "final payment by owner to contractor under the Contract."¹⁰⁵ A surety advanced this argument in a case in which the payment bond at issue contained the following language:

(2) The above-named Principal and Surety hereby jointly and severally agree with the Obligees that every claimant as herein defined, who has not been paid in full before the expiration of a period of ninety (90) days after the date which the last of such claimant's work or labor was done or performed, or materials were furnished by such claimant, may sue on this bond for the use of such claimant, prosecute that suit to final judgment for such sum or sums as may be justly due claimant, and have execution thereon.¹⁰⁶

The court rejected the surety's argument:

The bond is absolute on its face. Accordingly, the obligation which it secures is also absolute The only limitation imposed is upon claimants who did not have a direct contract with the principal. In that case, the contract provides for payment within ninety (90) days of notice.¹⁰⁷

"[T]he very purpose of securing a surety bond contract is to ensure that claimants who perform are paid for their work *in the event that the principal does not pay*. To

¹⁰³ *Moore Brothers Co. v. Brown & Root, Inc.*, 207 F.3d 717, 723 (4th Cir. 2000).

¹⁰⁴ *But see United States ex rel. Walton Tech., Inc. v. Weststar Eng'g., Inc.*, 290 F.3d 1199, 1205 (9th Cir. 2002) ("The liability of a surety and its principal on a Miller Act payment bond is coextensive with the contractual liability of the principal only to the extent that it is consistent with the rights and obligations created under the Miller Act.")

¹⁰⁵ *Aesco Steel, Inc. v. J.A. Jones Constr. Co.*, 621 F. Supp. 1576, 1578 (E.D. La. 1985).

¹⁰⁶ *Id.* at 1581.

¹⁰⁷ *Id.* at 1581.

suggest that nonpayment by the owner absolves the surety of its obligation is nonsensical, for it defeats the very purpose of a payment bond.”¹⁰⁸

In *Brown and Kerr, Inc. v. St. Paul Fire & Marine Insurance Co.*,¹⁰⁹ St. Paul had issued a payment bond providing that every claimant who had not been paid in full before the expiration of ninety (90) days after the date on which the claimant last performed work or furnished material “may sue on this bond for the use of such claimant”¹¹⁰ The subcontract contained a pay-when-paid provision. The payment bond did not condition final payment to claimants on the owner having made final payment to the bonded principal and did not incorporate the payment terms of the subcontract.¹¹¹ St. Paul’s defense relied exclusively on the general rule that the liability of a surety under a payment bond is co-equal with that of its principal. St. Paul argued that because its principal had not yet been paid, the subcontractor had no right to payment under the payment bond. The district court disagreed:

[The subcontractor] is suing under the bond and not the subcontract. The two are separate agreements. St. Paul has neither cited, nor have we discovered, any authority for the proposition that the inability to proceed against the general contractor because of a “pay-when-paid” clause in the subcontract necessarily prevents recovery against the surety under the payment bond. Indeed, such an argument runs counter to the underlying purpose of the payment bond, i.e., the assurance of payment to subcontractors.¹¹²

The court also held that the payment bond did not contemplate that payment of a subcontractor should await the determination of an extended legal dispute between upper-stream parties concerning work completely unrelated to the work of the subcontractor:

¹⁰⁸ *Id.* at 723 (emphasis in original).

¹⁰⁹ 940 F. Supp. 1245 (N.D. Ill. 1996).

¹¹⁰ *Id.* at 1246-47.

¹¹¹ *Id.* at 1249.

¹¹² *Id.* at 1249.

We do not believe the bond contemplates that payment of subcontractors should await the determination of an extended legal dispute between the owner and general contractor concerning his work which is completely unrelated to [the subcontractor], particularly since the underlying purpose of the bond is to assure the payment of subcontractors and when, as here, [the subcontractor] has completed performance under the subcontract.¹¹³

3. Mandamus

State statutes may provide a basis for a mandamus proceeding to require a public entity to make payments. The plaintiffs in a mandamus action must have a clear legal right to payment.¹¹⁴ Generally, mandamus will not lie to compel the payment of an unliquidated, unascertained, or doubtful claim against a public entity.¹¹⁵ In addition, mandamus generally will not lie if another specific legal remedy exists. However, when the public entity's real property is totally exempt from levy and sale, and the entity is authorized to pledge all or part of its revenues to secure the payment of bonds, a suit upon the contract and the judgment rendered would not afford the plaintiff an adequate remedy for the enforcement of its claim.¹¹⁶ A court may find that an adequate remedy at law does

¹¹³ *Id.* at 1249; see also *Bonavist v. Inner City Carpentry, Inc.*, 244 F. Supp. 2d. 154, 159 (E.D. N.Y. 2003) (pay-when-paid limitation in payment bond deemed unenforceable as against public policy); *Walter Diving Contractors, Inc. v. The Travelers Indem. Co., No. 88-5702*, 1989 WL 46091, at *4 (E.D. Pa. Apr. 25, 1989); *United States ex rel. TMP Mechanical Contractors, Inc. v. Millers Mut. Fire Insur. Co. of Texas*, 942 F.2d. 946, 949 n.6 (5th Cir. 1991); *United States ex rel. Walton Tech., Inc. v. Weststar Eng'g., Inc.*, 290 F.3d 1199, 1204 (9th Cir. 2002); *Morganti Nat'l, Inc. v. Petri Mechanical Co., Inc.*, No. 3-98CV309, 2004 WL 1091743 at *11; (D. Conn. May 13, 2004).

¹¹⁴ *Housing Authority of The City of Carrollton v. Ayers*, 88 S.E.2d 368, 369 (Ga. 1955) (“[T]he plaintiff in a mandamus must have the clear legal right to have performed the particular act which he seeks to have enforced . . .”).

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 370 (architect's petition for mandamus appropriate on written contract providing for compensation calculated according to fixed mathematical formulas; where housing authority executed certificates of final acceptance of projects, petition clearly stated a liquidated claim).

not exist when a court action would cause a lengthy delay that would result in serious economic harm.¹¹⁷

IV. HITTING BOTTOM: TERMINATION FOR DEFAULT

A default termination is a drastic sanction which should be imposed only for good grounds and on solid evidence.¹¹⁸ After due consideration of the alternatives to avoid a termination for default, it may nevertheless become evident that termination for default is unavoidable. This section of the paper will review the AIA A201 contract provisions concerning default termination by the contractor and by the owner. It will also analyze the remedies and damages available to the parties upon termination for default.

A. Contract Provisions

A review of the contract that governs the parties' relationship is imperative before the decision to terminate is made. The provisions of the contract must be followed exactly to avoid a finding of wrongful termination. The surety must be notified in accordance with the provisions of the bond, the contract, and any applicable statutory provisions.

1. Termination by the Contractor

Article 14.1.1 of the AIA A201 provides the standards for the contractor's termination of its contract with the owner for cause as follows:

1. Issuance of an order of a court or other public authority having jurisdiction which requires all work to be stopped;
2. An act of government, such as a declaration of national emergency which requires all work to be stopped;

¹¹⁷ *State of Ohio ex rel. The Horvitz Co. v. Reibe*, 354 N.E.2d 708, 711 (Ohio Ct. App. 1975) (allowing writ of mandamus where court found the remedy of an action at law on the contract is "neither complete nor speedy").

¹¹⁸ *Sipco Servs. & Marine, Inc. v. United States*, 41 Fed. Cl. 196, 220 (Fed. Cl. 1998).

3. Because the architect has not issued a certificate for payment and has not notified the contractor of the reason for withholding certification, or because the owner has not made payment on a certificate for payment within the time stated in the contract documents; or
4. The Owner has failed to furnish to the Contractor promptly, upon the Contractor's request, reasonable evidence of the owner's ability to fulfill its financial obligations.¹¹⁹

In addition, the contractor may terminate the construction contract upon repeated suspensions, delays or terminations of the work by the owner.¹²⁰ Finally, the contractor may terminate if the work is stopped for sixty consecutive days through no fault of the contractor or its agents and employees and due to the owner's failure to fulfill its obligations respecting progress of the work.¹²¹ The contractor must provide a seven-day written notice to the owner and the architect prior to terminating the contract.¹²²

2. Termination by the Owner

Section 14.2 of the AIA A201 provides the standards for the owner's termination of its contract with the contractor for cause as follows:

The owner may terminate the contract if the contractor:

1. persistently or repeatedly refuses or fails to supply enough properly skilled workers or proper materials;
2. fails to make payment to contractors for materials or labor in accordance with the respective agreements between the contractor and the subcontractors;
3. persistently disregards laws, ordinances, or rules, regulations or orders of a public authority having jurisdiction; or
4. otherwise is guilty of a substantial breach of a provision of the contract documents.

¹¹⁹ AIA A201-1997, Art. 14.1.1.

¹²⁰ AIA A201-1997, Art. 14.1.2. The aggregate period of delay must be more than one hundred percent of the total number of days scheduled for completion, or 120 days, whichever is less. *Id.*

¹²¹ AIA A201-1997, Art. 14.1.4.

¹²² AIA A201-1997, Art. 14.1.3, 14.1.4.

Under the AIA A201, the owner may not unilaterally declare cause sufficient to terminate the contract. Prior to termination for cause, the architect must certify that sufficient cause exists to justify termination.¹²³

B. Remedies Upon Termination for Default

Various remedies are available to the owner or contractor upon termination for default. Under the AIA A201, the owner is entitled to take possession of the site, tools, and equipment of the defaulted contractor; accept assignment of subcontracts; and finish the work in any manner deemed expedient.¹²⁴ Under the AIA A201, the contractor is entitled to recover payment for work executed, and for proven loss for materials, equipment, and tools, including reasonable overhead, profit, and damages.¹²⁵ The case law also affords remedies to the parties.

1. Damages Upon Termination for Cause

Upon termination for cause, the law will attempt to place the parties in the position they would have held had the terminated party fulfilled its contractual obligations. The owner or general contractor that terminates a general contractor or subcontractor, as the case may be, will be entitled to recover any completion costs that exceed the unpaid balance of the contract price.¹²⁶ The terminating party must act reasonably and mitigate its losses and cannot recover the full cost of completion under

¹²³ AIA A201-1997, Art. 14.2.2.

¹²⁴ AIA A201-1997, Art. 14.2.2.

¹²⁵ AIA A201-1997, Art. 14.1.3.

¹²⁶ 6 Philip L. Bruner and Patrick J. O'Connor, Jr., *Bruner & O'Connor Construction Law* § 19:56 (2007); see also *Orto v. Jackson*, 413 N.E.2d 273, 277 (Ind. Ct. App. 1980) (awarding damages for cleanup and repair costs resulting from defective construction of sewage system).

the contract price if the project may be completed at a lower cost.¹²⁷ If the contract can be completed within the unpaid contract funds, then the terminating owner or general contractor incurs no damages and must pay any balance remaining to the terminated party.¹²⁸

Along with general damages, courts have allowed a wide range of consequential damages to owners when a contractor defaults. Such consequential damages may include damages for the loss of the full use and enjoyment of the structure¹²⁹ or profits lost from the use of a commercial building.¹³⁰ More liberal consequential damages have been awarded in cases involving homeowners.¹³¹

2. Damages Upon Wrongful Termination

In the event of a wrongful termination, the terminated party may prevail on a damages claim. A contractor that has been wrongfully prevented from completion of its contract is entitled to an amount that would place the contractor in a position equivalent to that which the contractor would have occupied had the contract been performed fully.¹³² The contractor may also recover damages sustained by reason of the owner's

¹²⁷ *Louise Caroline Nursing Home, Inc. v. Dix Const. Corp.*, 285 N.E.2d 904, 907-08 (1972).

¹²⁸ *Id.*

¹²⁹ *Raven's Cove Townhomes, Inc. v. Knuppe Dev. Co.*, 114 Cal. App. 3d. 783, (Cal. Ct. App. 1981).

¹³⁰ *Smart v. U.S. Fidelity & Guaranty Co.*, 513 S.W.2d 291, 296 (Tex. Ct. App. 1974) (awarding \$10,000 for loss of veterinary medicine practice resulting from delayed building construction).

¹³¹ *See, e.g., Whitener v. Clark*, 356 So. 2d 1094, 1098 (La. 1978) (awarding damages for mental anguish caused by shattering dream of owning a home); *Master Maintenance Eng'g, Inc. v. McManus*, 292 So. 2d 284, 289 (La. Ct. App. 1974) (awarding damages for cost of renting a place to live and interim financing caused by delays).

¹³² *Dankowski v. Cremona*, 352 S.W.2d 334, 336 (Tex. Ct. App. 1961).

breach, including the profits the contractor would have earned had it been permitted to perform.¹³³

The owner or general contractor who wrongfully terminates its contractor or subcontractor, as the case may be, risks being unable to recover the costs to complete the work. The terminating party may be responsible for contract payments through the date of termination and may be potentially liable for lost profits on the work that has not yet been performed.

Lost profits claims for uncompleted work are in most cases subject to attack as being overly speculative or not within the contemplation of the parties.¹³⁴ However, some states have a relaxed standard of review for such claims.

For example, Maryland considers lost profit damages foreseeable for sellers in a business transaction because making a profit is the reason for the transaction.¹³⁵ Maryland has modified the ‘certainty’ rule to one of ‘reasonable certainty’ in addressing the speculative nature of lost profits claims:

(a) if the fact of damage is proven with certainty, the extent or the amount thereof may be left to reasonable inference; (b) where a defendant’s wrong has caused the difficulty of proving damage, he cannot complain of the resulting uncertainty; (c) mere difficulty in ascertaining the amount of damage is not fatal; (d) mathematical precision in fixing the exact amount is not required; (e) it is sufficient if the best evidence of the damage which is available is produced; and (f) the plaintiff is entitled to recover the value of his contract as measured by the value of his profits.¹³⁶

The terminated party might also try to claim an entitlement to profits on other jobs it could not bid because of its diminished bonding capacity. At least one court has

¹³³ *Id.*

¹³⁴ *See, e.g., Nohcra Communications, Inc. v. AM Communications, Inc.*, 909 F.2d 1007, 1011 (7th Cir. 1990) (applying Pennsylvania law).

¹³⁵ *M&R Contractors & Builders, Inc. v. Michael*, 138 A.2d 350, 354 (Md. 1958).

¹³⁶ 138 A.2d at 355.

allowed claims for lost potential profits on jobs a contractor could not bid as a result of diminished bonding capacity.¹³⁷ However, that court recognized that the award was “to some degree speculative.”¹³⁸

C. Notice to the Surety

Timely notice to the surety is required if a terminating party (the owner or the contractor obligee) expects to call on the surety’s performance bond to fulfill the terminated party’s obligations. While some courts have held that, absent specific notice requirements in the performance bond, there is no requirement that the surety be notified prior to declaring a default and terminating the contractor,¹³⁹ the better practice is to notify the surety promptly. Moreover, the construction contract itself may require that notice be provided to the surety.¹⁴⁰

Beneficiaries of the bond will be bound by the terms of the bond.¹⁴¹ If the bond includes particular notice requirements, they will be enforced. If proper notice is not provided within the time and in the form required by the terms of the bond, the terms of the construction contract, or the terms of any relevant statute, the surety may be relieved of its obligations under the bond.¹⁴² The claimant’s notice obligations continue beyond project completion if bond coverage is sought for subsequently discovered defects. An

¹³⁷ See, e.g., *Tempo, Inc. v. Rapid Elec. Sales & Serv., Inc.*, 347 N.W.2d 728, 733 (Mich. Ct. App. 1984).

¹³⁸ *Id.*

¹³⁹ See, e.g., *School Dist. No. 65R of Lincoln County v. Universal Surety Co.*, 135 N.W.2d 232, 237 (Neb. 1965).

¹⁴⁰ AIA A201-1997, Art. 14.2.2.

¹⁴¹ *Lynbrook Glass and Architectural Metals Corp. v. Elite Assoc., Inc.*, 225 A.D.2d 525, 526 (N.Y. App. Div. 1996).

¹⁴² *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166, 178 (D. Mass. 2003) (owner’s failure to provide seven-day default notice to contractor as required by AIA A201 relieved surety from its liability under the bond); see also Bachrach, *supra* note 62, at Part III.B.2.

owner who repairs construction defects prior to notifying the surety may be unable to recover under the bond.¹⁴³ The notice provisions of the AIA A311 and A312 performance bond forms are discussed in the companion paper by George J. Bachrach.¹⁴⁴

V. CONCLUSION

The distressed construction project presents many challenges and considerations for the parties and their counsel. The decision to terminate for default should be viewed as a last resort, and alternatives to avoid termination for default should be considered. Careful analysis will be required to identify whether a breach rises to a level that warrants termination for default. Parties who choose to terminate for default should follow the relevant contract terms to minimize the risk of finding a wrongful termination.

¹⁴³ *Insurance Co. of North Am. v. Metropolitan Dade County*, 705 So. 2d 33, 34-35 (Fla. 1977) (surety relieved of liability where owner did not give notice until five months after completing repairs).

¹⁴⁴ See Bachrach, *supra* note 62, at Part III.B.2.