HANDLING THREATS OF CONTRACT TERMINATION

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Termination is the ultimate threat in a construction project. The owner may threaten termination of a contractor who fails to perform; conversely, a contractor who is not being paid in accordance with the contract documents may threaten termination.

In most cases, termination is a losing proposition for both parties. If you terminate, it will most likely cost you money, even if the termination is proper. Therefore, it is vitally important that you understand when and how a termination can legally occur and how to handle such termination threats.

Termination can be for default or for convenience.

A. Termination for Default

Both the contractor and the owner have a right to terminate for default.

Contractor's Termination for Default

A contractor may terminate the contract for a material breach pursuant to A201 para. 14.1.1. This provision provides that a contractor may terminate the contract if the Work is stopped for 30 or more days through no fault of the Contractor, for specified reasons only, which include:

- issuance of a governmental stop-work order;
- an act of government such as declaration of national emergency;

- failure of prompt payment or failure to issue a Certificate of Payment with no notified reason for the failure to issue such a certificate; or

- failure of the owner to show financial capability upon request.

Additionally, a contractor can terminate the Contract for cause if it experiences repeated suspensions, delays or interruptions of the Work in the following delay situations:

- more than 100% of the total number of days scheduled for completion, or 120 days in any 365 day period, whichever is less. (14.1.2); *or*
- if work is stopped for 60 consecutive delays through the fault of the owner. (14.1.4).

Owner's Termination for Default

Pursuant to A201 para 14.2.1, the owner can terminate for cause as well, if the contractor materially breaches the contract in one or the following ways:

- persistently fails to supply enough properly skilled workers or proper materials;

- fails to make payment to Subcontractors for materials or labor in accordance with the respective agreements;

- persistently disregards laws, ordinances, or rules, regulations or orders of a public authority having jurisdiction; or

- otherwise is guilty of substantial breach of a provision of the Contract Documents.

Termination for cause must be for breaches which are "so material as in effect to defeat the very terms of the contract." *Opsahl v. Pinehurst, Inc.*, 81 N.C. App. 56,

64, 344 S.E.2d 68, 73 (1986), *quoting Childress v. Trading Post*, 247 N.C. 150, 156, 100 S.E.2d 391, 395 (1957).

Practice Tip: If termination is likely, and you as the contractor are at fault, it makes economic sense to demonstrate to the owner your commitment to correct any problems, including working overtime, doubling forces, etc. The acceleration costs will usually be less than costs of actual termination, lost cash flow, and legal expenses. This is because if a contractor is terminated for cause, he risks paying for delays to the owner for completion. Completing a terminated scope of work with a different contractor is almost always more expensive. Further, if a performance bond is in place, it will be called on immediately, and most such bonds require indemnity agreements from the principals of the contracting firm.

B. Termination for Convenience

Only the owner can terminate, or suspend, the contract for convenience. The contractor is not vested with this right.

With written notice, the owner can suspend the project for convenience under 14.3.1. This power is completely discretionary with the owner. However, in such a case, the contract sum and time are adjusted for increases caused by the suspension, delay, or interruption. (14.3.2).

Furthermore, the owner can terminate the contractor at any time for convenience under 14.4.1. Upon receipt of written notice, the contractor shall cease operations as directed, take necessary actions to protect and preserve the Work, and terminate all subcontracts and purchase orders. (14.4.2).

In the case of such termination for the Owner's convenience, the Contractor shall be entitled to receive payment for Work executed, and costs

incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed. (14.4.3)

C. Wrongful Termination

Wrongful Termination of Contract by Owner

If a contractor is terminated without cause, but the owner states that the termination is "for cause," the contractor can sue to recover for wrongful termination. The contractor would be entitled not only for compensation for work performed prior to termination, but also the net profit the contractor anticipated making on the unperformed portion of the contract.

Termination for failure to complete on time would be wrongful, unless the contract contains valid "time is of the essence" language. Without a "time is of the essence" clause, failure to complete on time would not give the owner the right to terminate for cause. *Opsahl v. Pinehurst Inc.*, 81 N.C. App. 56, 344 S.E.2d 68 (1986).

Moreover, it would be wrongful for the owner to terminate after substantial performance of the contract by the contractor. That is, once the contractor has substantially performed his part of the work, the owner is not allowed to rescind or terminate the contract based on immaterial breaches.

Wrongful Termination of Contract by Contractor

If a contractor wrongfully terminates a contract and leaves the job, he will be held liable for the difference between the owner's cost to complete and the remaining contract balance. He would also be required to pay reasonable extra costs associated with the delay and the hiring of a new contractor.

For example: Owner and contractor enter into a lump-sum contract in the amount of $500,000 for the construction of a building. After 75% of the building is completed, and $375,000 has been paid to the contractor, the contractor terminates the contract by walking off the job. Owner has to hire another contractor to finish the remaining 25% of the work. Instead of costing $125,000 (the remaining contract balance), the new contractor charges the owner $200,000 due to the rushed conditions and half-finished status of the building. Additionally, the owner incurs $5,000 in delay costs and $10,000 in increased materials costs. The owner is entitled to obtain the extra $75,000 contractor fee, as well as the $15,000 in substantiated extra costs, from the original, defaulting contractor.

D. Steps to Proper Termination

To ensure no charge can be made for wrongful termination, you should be sure that (1) cause exists for termination; and (2) procedures are followed to terminate properly.

Contractor's Proper Termination

Prior to termination, the contractor can elect to suspend the work if timely payments are not made by the owner (9.7.1). This is a safer course of action than termination, and it allows the owner a chance to cure.

If the contractor must terminate for cause, he must provide a 7 day written notice to the owner (14.1.4).

Owner's Proper Termination

Although not required prior to termination, the owner can elect to exercise its right to stop work prior to taking the more drastic remedy of termination. The

owner can stop the work if it is not proceeding in accordance with the plans, and the contractor's breach is substantial. (2.3.1). This is a recommended first step prior to termination. Further, the owner can elect to carry out portions of the work itself, provided it follows the notice requirements and gives the contractor an opportunity to comply. (2.4).

Prior to termination, the owner must give a 7 day written notice to the contractor. (14.2.2).

After termination, the owner is permitted to choose any reasonable method for completing the work and charge that cost to the defaulting contractor, whether or not that method is the best method or the cheapest method. (14.2.2.3).

Practice Tip: Regardless whether you are the contractor or owner, if you are attempting to terminate for cause by asserting a default by the other party, you should also reserve the right to later assert other reasons for the default by stating, "You are in default for X reason. This notice does not waive our right to assert other reasons for your default."

E. Available Remedies or Damages

Whenever a party breaches a contract, the non-breaching party is entitled to recover some form of damages. In all contract actions, a breach entitles the other party to at least nominal damages, and actual damages which they can prove. In the case of termination, the actual damages must be shown to be the proximate result of the termination.

Contractor's Damages

If a contractor terminates the contract for cause, he is entitled to recover payment for Work executed and for proven loss with respect to materials,

equipment, tools, and construction equipment and machinery, including reasonable overhead, profit and damages. (14.1.3).

Similarly, if an owner terminates the contract for the owner's convenience, the contractor is entitled to recover payment for Work executed, and costs incurred by reason of such termination, along with reasonable overhead and profit on Work not executed. (14.4.3)

If a contractor is wrongfully terminated, the contractor is entitled to the unpaid contract price earned (cost) plus lost profits (contract price minus costs to complete contract). The contractor may be able to recover special damages (such as lost profits) if he can prove those damages were contemplated by the parties when executing the contract, and the damages are reasonably certain and not speculative. *Compton v. Kirby*, 157 N.C. App. 1, 577 S.E.2d 905 (2003); *Mosley & Mosley Builders, Inc. v. Landin LTD.*, 87 N.C. App. 438, 361 S.E.2d 608 (1987).

In the case of a subcontractor which has defaulted, the general contractor is entitled to recover from that subcontractor any increased costs of completing the work from defaulting subcontractor.

Owner's Damages

For a contractor's breach or an owner who terminates for cause, the owner's damages can be either the cost of repair/completion or the difference in value from what was contracted. In general, cost of repair is the proper measure of damages in a construction case where the owner would not get what he bargained for unless he gets the repair, replacement or completion. *TC Arrowpoint, L.P. v. Choate Construction Co.*, 2006 WL 91767 (W.D.N.C. 2006). If the unpaid contract balance exceeds the costs of finishing the Work, the contractor should be reimbursed the difference. If the work to finish is greater

than the balance remaining, the contractor shall pay the difference to the owner. (A201, para 14.2.4).

An exception to the cost of repair method of calculating damage exists, however, where a substantial portion of the completed work would be destroyed to undertake the repair. In that case, diminution in value may be used as the measure of damages instead, provided the structure substantially conforms to the contract specifications. *City of Charlotte v. Skidmore, Owings and Merrill*, 103 N.C. App. 667, 407 S.E.2d 571 (1991). If, however, the defects or omissions are major, such that the building does not substantially conform, then the decreased value of the constructed building justifies the high cost of repairs. *Id.*

Interest on Damages

Interest runs from the date of the breach until the judgment is satisfied, at the legal rate of 8% per annum, unless the parties have agreed otherwise. However, any agreement concerning interest is controlling with respect to post-judgment interest only if the agreement specifically so states. N.C. Gen. Stat. §24-1; §24-5; *Barrett Kays & Assoc, P.A. v. Colonial Building Co., Inc. of Raleigh*, 129 N.C. App. 525, 500 S.E.2d 108 (1998).

Under A201, interest runs on any due and unpaid sums from the date the payment is due at either the contracted rate, or the legal rate if none is specified. (13.6.1).

Attorney Fees

Some contracts state that they allow for recovery of attorney fees. These provisions will only be enforced if there is a statutory basis for recovery of such fees. *Lee Cycle Center, Inc. v. Wilson Cycle Center, Inc.*, 143 N.C. App. 1, 545 S.E.2d 745 (2001). Two types of attorney fee provisions which are allowed are those pursuant to a written evidence of indebtedness (N.C. Gen. Stat. §6-21.2) and

those related to the perfection of a lien on real property (N.C. Gen. Stat. §44A-35). Therefore, the contractor stands a much stronger chance of recovering attorney fees than an owner does in the construction context.

Keep in mind, however, that the standard A201 provides for mandatory arbitration. If the arbitration provision is kept as written, no attorney fees can be awarded for the arbitration itself. N.C. Gen. Stat. §1-567.11; *PHC, Inc. v. N.C. Farm Bureau Mutual Insurance Co.*, 129 N.C. App. 801, 501 S.E.2d 701 (1998). The parties could add to the arbitration clause a provision awarding attorney fees to the prevailing party. Again, check with your legal counsel as to the risks and benefits of such a provision.

Summary Tip: Termination is a lose-lose proposition for all parties. Endeavor to provide notice and the opportunity to cure defects instead. If termination is necessary, be sure to follow your contractual responsibilities, document the state of the work at the stop-work point (including pictures if possible), and prepare for litigation which is likely to follow.