**Construction and Design Law: Managing the Network of Interdependent Relationships**

Carl J. Circo

**Lesson 15: Material Defaults and Termination**

A material default is a breach of contract that authorizes the party not in default to terminate the contract. Contract termination refers to the premature ending of the ongoing contractual relationship. Termination in this sense does not render the contract invalid or unenforceable; rather, it means that the parties will no longer continue to perform their contractual obligations. Under general principles of contract law, the parties may, of course, mutually agree to terminate their relationship, but construction industry disputes often develop when one party claims a legal right to terminate unilaterally.

As already noted, termination can occur under common law principles when one party materially breaches and the other party elects to end the contractual relationship. Alternatively, termination can occur in accordance with express contractual provisions giving a party the right to terminate, either due to the other party’s default (which may or may not qualify as a material default at common law) or based on other specified termination conditions, such as an extended suspension of the work or a judicial order or governmental act requiring the work to stop. In the construction industry, terminations of these kinds are “for cause.”

Construction contracts often give the owner the unilateral privilege to terminate the contract without cause, referred to as a termination for convenience. For many owners a broad termination for convenience option serves as a hedge against unanticipated developments, such as financial misfortunes, a downturn in business prospects, or the loss of a key customer or tenant for the project. Termination for convenience clauses normally require the owner to pay a specified termination fee. Provisions for calculating the termination fee vary, and they sometimes become the subject of detailed contract negotiations. The most common provisions at least require the terminating party to compensate the terminated party for work performed (usually including overhead and profit) and for certain costs associated with the termination, and some also require an additional payment for lost profits on work not yet performed. See Josh M. Leavitt, *Toward a Unified Theory of Damages in Construction Cases: Part III—Damages in Terminations for Convenience*, 6 J. Am. Coll. Constr. Laws 3 (July 2012).

A decision to terminate frequently generates one or more significant legal issues. The most basic question is whether the termination is legally valid. It may not be, either because the terminated party was not in material default and no other contractually expressed or implied conditions for termination have been satisfied, or because the terminating party did not comply with the contractually specified termination procedures. A wrongful termination is a material breach that may support breach of contract remedies. Even if the termination is legally valid, the parties may disagree over their resulting rights and obligations. For example, if the basis for termination is a material default, the terminating party will usually seek damages, either under common law principles or as specified in the contract’s termination provisions, yet the party in default may still be entitled to compensation or credit for contractual obligations performed prior to the termination. If the termination is based on a contractually specified cause other than breach or if it is for convenience, the relevant contract provisions should govern the parties’ rights and obligations following termination, but the parties may disagree about the proper interpretation or application of those provisions.

Considerable risks attend almost any decision to terminate a construction contract, unless the parties have mutually agreed to a termination, which will likely require a carefully negotiated settlement agreement. An extended and expensive dispute resolution process may result if the terminated party claims that the termination was wrongful, either on substantive or procedural grounds. As already noted, complex disputes may also arise over the parties’ rights and obligations following a legally valid termination. Beyond such legal issues, termination usually creates many practical problems. For example, the owner will typically need to find a replacement contractor (who will likely charge more than the original contract price), may incur significant problems with the construction lender and possibly with tenants or other end users, and will otherwise need to deal with significant delays and costs attributable to an incomplete project. A termination also will likely create serious financial problems for a general contractor and may give rise to claims and disputes with subcontractors and suppliers. Similar complications will attend terminations of design professionals, contract managers, subcontractors, suppliers, and other project participants. Anyone considering termination should seek advice from experienced legal counsel before taking action. In many, if not most, circumstances, better alternatives will be available to avoid termination and its associated risks.

With these preliminary considerations in mind, read *Management of Contract Terminations from Multiple Perspectives*, 42 Constr. Law. 23 (Summer 2022), by John P. Ahlers, Cameron Sheldon, and Hanna Lee Blake. This article covers the most important issues that commonly arise in connection with both terminations for cause and terminations for convenience. Section I addresses the material default concept and related issues. In that context, subsection I.C discusses the possibility that a party initially declaring a termination for cause may subsequently attempt to “convert” the termination so that it will be enforced under the contract’s termination for convenience option. Sometimes, especially for federal projects, the contract or applicable law gives the owner this right. As the authors discuss, some cases permit this maneuver, while others deny or restrict the option. In essence, conversion to termination for convenience allows the terminating party to substitute an obligation to pay the contract’s termination for convenience fees rather than to incur liability for much harsher breach of contract damages for wrongful termination. Disputes may also arise when a party who has declared a termination for convenience later wishes to convert the termination to one for cause in order to pursue breach of contract damages rather than having to pay a contractual termination fee. These and related issues are also discussed in *Termination for Cause or Convenience: What Happens if You are Wrong?,*  13 J. Am. Coll. Constr. Laws 4 (Winter 2019), by Deborah S. Ballati and Marlo Cohen and in *Toward a Unified Theory of Damages in Construction Cases: Part III—Damages in Terminations for Convenience*, 6 J. Am. Coll. Constr. Laws 3 (July 2012), by Josh M. Leavitt.

In Section II of their article, Ahlers, Sheldon, and Blake offer practical advice for owners and contractors contemplating or facing termination. As they explain, in addition to determining whether a sufficient basis exists for terminating, it is important for the parties to review the contract’s termination procedures. Contracts usually at least require advance notice of an intent to terminate for cause, and they may also afford the party allegedly in default the right to cure, or they may include procedures that otherwise create an opportunity to resolve the problem and avoid termination. Subsection 14.2.2 of the 2017 version of AIA A201 conditions the owner’s right to terminate the general contractor for cause on securing the project architect’s certification that sufficient cause exists. Such a provision, or other involvement of an owner’s consultant in a decision to terminate, sometimes generates interesting legal issues, including the risk that the terminated contractor may sue the architect or other consultant for defamation or tortious interference with the owner-contractor relationship. See Mark J. Heley & Mark A. Bloomquist, *The Design Professional's Role in the Termination of the Contractor*, 17 Constr. Law. 3 (April 1997).

Finally, in Section III the authors cover some special considerations applicable to terminations when the terminated “principal” (the general contractor or subcontractor) has furnished a performance bond naming the terminating party (the owner or general contractor) as the “obligee” under the bond. This last topic offers the opportunity to review some basic principles of suretyship law in the termination context. The basic concept is stated in Section III at page 26: “As a general rule, a surety's liability is coextensive with that of its principal and a surety is unlikely to be liable to complete its principal's work in the absence of the principal's material breach of the underlying contract. In deciding whether to terminate the principal, the obligee should be certain that the principal is in default of its performance obligations and that the obligee has complied with all procedural requirements within both the contract and bond to trigger surety liability.” Thus, the obligee under the bond must not only establish the principal’s default and comply with the termination procedures specified in the contract, but must also take the steps required under the bond to trigger the surety’s obligations. Even then, as the authors explain, provisions of the bond will determine the extent of the surety’s obligations and the alternative courses of action the surety may take to satisfy those obligations. Additionally, the surety may raise special defenses available to it under suretyship law.

Now read the following two cases, which illustrate judicial approaches to some aspects of the termination issues discussed in the article by Ahlers, Sheldon, and Blake.

* *Carolina Consulting Corp. v. Ajax Paving Industries, Inc. of Florida*, 86 So. 3d 502 (Fla. Dist. Ct. App. 2012) This case discusses the propriety of a general contractor’s termination of a subcontract for cause under unusual circumstances. Note also how the payment bond provided by the general contractor in accordance with Florida law affected the subcontractor’s wrongful termination argument.
* *Krygoski Constr. Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996). This case explains policy-based limitations on the termination for convenience option even where the applicable contract clause seemingly gave the government the unrestricted right to terminate so long as the contracting officer determined that doing so was in the government’s interest. Also note the court’s discussion of the history of the federal government’s right to terminate a contract for convenience.

For Review and Discussion

1. Assume that your client is a project owner who is considering terminating the general contractor due to multiple, extended delays in making progress toward completion on time. Write a memo to your client concerning the likely risks involved in terminating the general contractor. What additional information do you need to advise the client on whether to terminate and what steps should be taken if the client decides to terminate?
2. Assume that you represent a general contractor who is negotiating the terms of a clause permitting the owner to terminate the contract for convenience. Discuss the specific provisions you will want the termination for convenience clause to include for your client’s protection.
3. As a matter of sound public policy, in instances in which an owner-contractor agreement includes a clause authorizing the owner to terminate for cause and another clause authorizing the owner to terminate for convenience, discuss whether a court should enforce a separate provision in the agreement stating that after the owner has given a notice of termination under one termination clause, the owner may elect to have the termination treated as being governed by the other termination clause.