Scribbles Squibs #24 (February 17, 2014): Seven Ideas on Avoiding and Minimizing Contract Terminations*

By Attorney Jonathan Sauer

I. INTRODUCTION. Other than not getting paid for what you are entitled to and *when* you are entitled to be paid, some of the most uncomfortable of all contractual matters occur when your company is defaulted or terminated or threatened with termination with regard to one of your contracts. What do these concepts mean? What are some ideas to employ in order to successfully handle them?

II. WHAT IS A CONTRACTUAL DEFAULT? Initially, there are a variety of 'defaults' as would apply to contracts you are involved with. Now, the kind of default we would be most concerned with is necessarily related to a material breach of contract, the subject of a previous *Squib* having to do with contracts. A default relative to a contract is a similar concept to a breach of a contract. Namely, this could be any situation where a party to a contract has not performed some aspect of its contract in accordance with applicable contractual provisions. Realistically speaking, this can be nearly an everyday event! Construction contracts are complex commercial transactions, deriving provisions from contract documents, bid documents, a variety of documents not dealing with a contract at your level – i. e. incorporated by reference, such as general contract provisions into a subcontract – along with, in some circumstances certain provisions of the law. But, are they all *equally* important?

Example. Suppose that your contract requires you to clean up your work every day. But, for whatever reason, on one particular day you failed to do so. Is that a breach of contract? Is that a technical default with regard to that contract? The answer to both questions is: 'yes'. But, the answer to both questions is that this would not be a material breach of contract. Consequently, this one day's lapse would not justify a default or a termination flowing from that default.

III. WHAT IS THE DIFFERENCE BETWEEN A 'DEFAULT' AND A 'TERMINATION'? Well, let's put it this way. There can be no justifiable termination unless there is an underlying default. But, not all defaults lead to a termination! A 'default' is a failure to comply with the contract documents. But, for a default to be legally significant, it has to be a 'material' default, which is analogous to a material breach of contract. Specifically, this has to be a matter of some *significance.* Now, having established *that,* to have a termination, this would not occur until your contractual party's having made the determination to pull the plug on the relationship, recognizing that this is not going to happen in all circumstances.

Why not? It may be because the other side isn't aware of your material breach or even fully aware of it. It may be because your 'default' was caused by other peoples' conduct, including the conduct of the very contracting party who might otherwise be insisting on your termination.

For example, your contract says you are going to man the job day-to-day until the work is done once you have received your notice to proceed. But, if a dependent trade was in your way and/or has not done enough preceding work for you to perform, this may justify your non-attendance with the result that your performance is not currently due.

It may be that your 'sin of omission or commission' is consistent with (not any worse than) the behavior of other parties at the job. It may also be that, on balance, your contracting party is not *that* upset with you. And, a reason many underperforming contractors get to keep their job is that if the other side defaults you, they may not know how else to get the job done in the same amount of same time and for the same price. For better or worse, your company has the benefit of whatever learning curve there might be for the job. Hopefully, you have the submittals and orders for long lead materials in process. And, The Great Teacher Himself said, 'let he who is without sin cast the first stone'. There is no one reading this – or, *writing* this – meeting this definition!

Another thing to remember about terminations is that a 'termination' doesn't mean that the contract ceases having legal significance or importance. Since a contract can only be modified by acts or omissions of both parties, one party's terminating the contract in no way impacts the continued existence of that contract. All that happens is that when one 'terminates the contract', one is simply terminating the right for further performance of work under that contract by the other contracting party. Something to keep in mind. If a contracting party on another contractual level terminates the performance of your contracting party – i.e. an owner terminates a general contractor and you are a subcontractor – there is case law saying that this terminates the performance of work on your subcontract, as well.

IV. THE TERMINATION FOLLOWS THE DEFAULT.

A default and a termination are different things. Think of it this way. If one speeds – and gets caught – that is the act of default. Losing one's license or getting heavily-fined reflects the termination. In other words, the act of termination follows the default. In order to have a viable termination, there first needs to be a viable material default.

V. FOUR COMMON CONSEQUENCES OF A TERMINATION.

(I) You may not be able to recover damages on a contract you have materially breached, been defaulted and terminated on. A termination is an extremely serious matter. For one thing, only a party substantially performing its contract is entitled to recover under the contract. People think that the idea of '*quantum meruit'* (Latin, a more or less dead language, meaning 'what it is worth') saves people in these circumstances. Actually, it doesn't. *'Quantum meruit'* is only a different form of valuing the performance under a contract, typically when, for some reason – and without fault – the party making the claim is prevented from completing its performance under the contract or whose performance is marred by only non-material errors. Both *quantum meruit* claims and contract claims depend on the party making the claim's having either completely performed its contract obligations or performed them to the point that circumstances or another party's acts prevented their complete performance. An example might be an inability to complete one's contract work because the building under construction burned down. Or, the owner ceased allowing performance on its building because it ran out of money, filed bankruptcy

or otherwise lost control of the construction project (i.e. a bank or other secured party took over the job.) Or, one can't perform one's contract because it was wrongfully terminated and the contractor was not allowed to complete its work.

(II) A declaration of default and termination can trigger a second party's liability, such as a surety under contract bonds. While many forms of insurance require a determination of the insured's fault prior to liability of the insurance company, a principal's default under a bonded contract is almost *always* something required before there is surety liability with few exceptions. One such exception is that a general contractor which has properly paid its subcontractors can still be liable to that subcontractors' labor and material suppliers under its payment bond if they were not paid by the subcontractor. (A principal reason for upstream parties' requiring lien waivers before making downstream payments.)

But, ordinarily, a principal's surety is only liable if the principal itself has in some manner breached its contract, whether by refusing to pay its debts to labor and material suppliers (payment bond), refusing to complete contract performance (performance bond) or refusing to execute a contract and provide payment and performance bonds when that party is the low bidder (bid bond). Like Moses crying in the wilderness – and, as some of the TV pastors say, *listen to me* - you cannot control what your surety will do with a claim against your payment, bid and performance bonds. This is especially true when your surety is a smaller surety or a substandard market surety or not your *current* surety. Your obligations to reimburse the surety for its loss and expense payments have nothing to do with your being right or wrong. You will indemnity even when you were right. There is a Massachusetts court case which says that indemnitors' claims that the surety acted in bad faith in resolving claims against it aren't even legal defenses to a claim for indemnity. Folks, unless you claim that it ain't your signature on the signature line on the general indemnity agreement (GIA), your chances of winning an indemnity suit brought by your surety simply aren't very good.

And, since better surety bond agents shop their accounts periodically to see if they can get cheaper bonding or more bonding (larger single bond limits and/or total programs) or to remove individual owners from the GIA as personal indemnitors, their ability to do so will be negatively affected by your having to admit on a bond application form that you have been 'in claim'. Whether you were right or whether you were wrong with regard to such claims probably aren't even the correct questions to answer. Being bonded on a project is like having your maiden aunt in the back seat when you and your squeeze are at a movie drive-in, assuming that there any are any still around (squeezes or drive-ins or both). You have to be constantly mindful of her presence and be sure to manage her and your expectations in some way that makes sense.

Put another way, your being in claim is simply not a good thing. Did I mention that your surety – the current one or the potential new one- couldn't care less whether you were right or not? Such a question won't even come up in the discussion. Your obligation to indemnify and hold harmless your surety is truly a no-fault obligation.

(III) If you are properly terminated, your contracting party can recover from you its excess costs of completing your contract work. This can be a very significant exposure. After all, if you were the low bidder, have already partially performed your trade's work, have had the benefit of a

job's learning curve, it will be very seldom that someone can finish your work more quickly or cheaper than you can. Judges and arbitrators, often knowing little about the construction industry and construction law issues, will often come up with rulings that will simply curl your toes. A termination for convenience, as opposed to traditional 'default' and 'termination' issues, does not depend on a prior determination of default or fault. This simply allows one to get rid of an underperforming contractor or subcontractor one no longer wants for any or *no* reason and, usually, without further resort to the court system to determine damages, as they are usually comprehensively provided for by contract provisions.

(IV). Litigation is expensive and it takes forever. Anyone who has much of an interest in going into court probably hasn't spent much time there. Cases in Massachusetts superior courts having to do with claimed construction breaches are likely to take at least five years to come to trial. If the plaintiff recovers damages, five years into that process, this would produce an interest factor of 60% (at least) of the actual damages. And, if there is going to be any level of discovery (i.e. more than one or two depositions), this case will cost you a minimum of twenty-five thousand dollars to prepare and try your case. More, if the case is complex and/or has expert witnesses. It is for these reasons that only about one percent of superior court civil cases result in a complete trial with a verdict or judgment. Perhaps the most expensive aspect of litigation is how much time this will take away from you from doing the two things that make you most of your money: estimating and running jobs. Answering document requests, interrogatories, requests for admissions, preparing for depositions and preparing for trial are going to take a *lot* of your own personal time.

In other places on our site – and in my writings – I speak about effective risk management. You don't want to put yourself through that process except in two situations. The first is that you have a very good idea you are likely to win, something that can be surprisingly hard to predict. The second is simply when you can't avoid the process, for one reason or another, such as in a case where the other side is very difficult and/or there is a lack of funds on the part of whoever rightly needs to pay to resolve the matter.

VI. HOW DO I PREVENT THESE THINGS FROM HAPPENING?

One has to keep in mind that a 'default' and a 'termination' are two different things. A legitimate 'termination' will require necessarily a prior 'material default'. You might ask: 'how do I keep from being terminated?' An excellent question and one that not enough people seem to ask before the event of termination occurs.

Here are seven ideas or strategies, among many others, that often work:

(I) **Get legal advice early enough for it to be useful to you and to put you in a position to potentially favorably affect the outcome of the dispute.** The law is not (necessarily) just 'common sense', although sometimes this might be the case (particularly when someone involved with the process gets confused.) In fact, Charles Dickens himself said that: ' the law is an ass'. (Consider the source. This in one of his most famous writings, 'The Bleak House', a novel about a long-running litigation in England's Court of Chancery, Jarndyce v. Jarndyce.) An analysis of a legal issue requires both certain analytical skills along with a substantive knowledge of the law, both with a healthy dose of objectivity, something we humans tend to lack when we

are ‘in the soup’. People hold off talking with lawyers because they are afraid of them, because they fear that they will not be able to tell the good ones from the bad ones and because of cost and loss of control issues. All legitimate concerns. And, we all have to be mindful of the fact that it’s simply a human tendency to grab onto inertia as if it were a life raft, particularly when we are in trouble. One should not lose sight of the fact, however, that issues *will* resolve themselves, either with or without our participation. And, usually, the results under the former will exceed those available under the latter!

(2) **It’s often a good strategy to complete the performance of your contract, even where your contracting party has materially breached it.** It’s a principle of law that if the other party to a contract has materially breached the contract, you are not required to further perform under that contract after the breach. Many of the cases holding this do so within the context of payment disputes. At the same time, there can be no absolute answer to whether further performance can be safely withheld until a court (possibly, an appellate court) declares the rights of the parties five years down the road. And, an important thing to understand about ‘court’ is that it is not necessarily about ‘right’ and ‘wrong’, sometimes, sadly, not particularly relevant concepts. With court cases, half the parties win and half lose. How many times in life would we consider these to be ‘good odds’? Would you bid/sign a job when you thought your chances were only 50-50 that you would make money? If you stop work because you are not getting paid, *maybe* you are right. But, what if you are *wrong?* If you are trying to protect a receivable, making sure that you have first materially performed your contract is part of the investment in trying to protect it. And, if you guess – or think – wrong, not only might you not be able to collect your receivable, you also might have to reimburse your contracting party for its costs in completing your contract, should you have ceased work under that contract without proper justification.

(3) **Make sure you study your contract carefully before you either terminate someone or while (during) your termination.** Terminating someone is more complex than one might imagine. Many systems of general conditions and industry forms of contract might require between two and three letters to get this done. The idea behind this is to give the ‘offending’ party an opportunity to ‘cure’ or correct a claimed poor aspect of its performance, which might be possibly something this party might not be (fully) aware of. So, a concept of fundamental fairness suggests that it is reasonable for the party whose contract is going to be mucked with to at least know of this before the contractual trigger gets pulled.

So, you may be required by your contract documents to give ‘notice of default’ or ‘notice of intention to terminate’ notices before you attempt actual contract termination. As these things go, usually the party receiving such a notice has seven to ten days to correct its behavior. Then, if it doesn’t, *then* termination can be attempted. There is a tendency for contractors to not have all of the contract documents at any particular time and/or to not *read* all of the contract documents before important actions such as termination are taken. If one gives a ‘defective’ termination notice, the giving of that notice itself might be seen by a court as a material breach of contract. Also, if you are the giver of such notices, make sure the receiver gets ‘actual’ notice, which would be either a signed green card or service by a disinterested third party, such as by a constable. Even if the contract in effect does not require both a notice of default and a

notice of termination, giving both of them will likely be seen by a court as evidence of your good faith.

(4) **If you are likely to be the terminating party, it might be preferable to insist on having a 'termination for convenience' clause in your contract.** To put it succinctly, when one considers 'ordinary' default and termination issues, a necessary ingredient is that the party being defaulted or terminated has done something *wrong*. And, the prior determination of this can be necessary to have an effective position and to best preserve oneself as to a claim for damages. With a termination for convenience, one can get rid of a contractual party without there being any question of fault. This minimizes the party's being defaulted filing a court case, as better termination for convenience clauses usually also specifically provide what recoverable termination costs will be.

(5) **Try to find a way to complete the job without getting terminated.** So, you've received a 'cure' notice. You don't necessarily agree with it. At the same time, you know that this job isn't going on your website as your best ever. Sometimes, someone's giving you a default notice or a termination notice is an indication that they are trying to get your attention. It might reflect anger, disappointment, probably some of each. Look, you're probably never going to work for this guy again. Find a way to get the job done and stay out of court. In the long run and in most situations, this will achieve the best result that can be accomplished in a difficult situation. Owners typically have a greater financial ability to litigate as compared with general contractors, as do general contractors when compared with subcontractors. An ability to simply maintain the costs of construction litigation can be necessary to getting to that decision years down the road. Avoiding the process whenever possible is often an effective business strategy.

(6) **Revenge, like ice cream, is a dish best served cold.** You already know this but I'll say it in any event. Don't make decisions when you are actively angry. This almost necessarily means that you are not 100% in a 'fully evaluative' mode. Decisions as to contract terminations and the litigations which frequently ensue are fraught with expense and uncertainty. Such decisions are among the most sober business decisions you will ever have to make.

(7) **Don't let your surety hear about claims against your bonds from claimants.** When it seems clear that you won't be able to fully manage or contain a certain situation, make sure your surety hears first about a possible claim directly from you, your presentation being well-detailed and well-documented. It's ok if your description of the situation favors you. The surety *expects* that. But, if you allow the surety to hear about a problem from the other side first, it'll be harder for you to get them to see your situation favorably down the road. Explaining your side of the problem before the other side does creates a better environment for your having your issue dealt with by the surety more to your liking. Doing otherwise contributes to an inference that your position isn't as valid as theirs. For, if it was, why did the surety have to first learn about this from the claimant, rather than from the principal with whom it has a long-standing business and contractual situation? Where indemnitors largely lack a legal ability to control what actions their sureties take in handling and resolving claims, not having your surety start spending money without your input is not likely to hurt your position.

VII. CONCLUSION.

That's the concern, the idea. Not to have a significant job problem resulting in *your* conclusion. Remember what the kidney stone doctor says: 'This, too, shall pass'. Of course, he/she might not say that unless you first have the correct medical insurance. Because, if you don't have that, he/she would not likely have seen you in the first place. But, on the brighter side, at least you wouldn't then have a co-pay! As good as we try to be, we can't settle all of life's problems in one sitting. If we could, we'd be God. Or, possibly, architects! Is God an architect? Now, *there's* something that might be *truly* scary!

Careful readers may have made note of the fact that only seven strategies are discussed above. Other strategies might be available and helpful with your situation. Getting a cowboy for whom this isn't his/her first rodeo can often really help!

****

* A *'squib'* is defined as 'a short humorous or satiric writing or speech'. If that definition doesn't float your boat, Wiktionary defines *squib* as: "a short article, often published in journals, that introduces empirical data problematic to linguistic theory or discusses an overlooked theoretical problem. In contrast to a typical linguistic article, a squib need not answer the questions that it poses." What the heck does *that* mean? That sounds like something that a politician might say. Or, something that a lawyer might say. And, have you noticed how many politicians are also lawyers? I mean, aren't you sorry you asked? And, what is this *thing* that contractors have with boats? What's wrong with, like, bikes? Or, for that matter, dogs? I mean dogs don't have a lot of bright work that has to be continuously cleaned and polished, otherwise to be lost to rust and corrosion. To be fair, a lot of bikes also have this problem with chrome and other shiny metals. Except for Harleys, which mostly come in any color you might want, provided that color is 'black'. They say they paint the bikes black to improve on their visibility. Outside of, like, bars. To, you know, attract girls and stuff.

Jonathan P. Sauer
Sally E. Sauer
Sauer & Sauer
15 Adrienne Rd.
E. Walpole, MA 02032
Phone: 508-668-6020
Fax: 508-668-6021
jonsauer@verizon.net
sallysauer@verizon.net
www.sauerconstructionlaw.com

****

(This article is not intended to be specific legal advice and should not be taken as such. Rather, it is intended for general educational and discussion purposes only. Questions of your rights and obligations under your contracts and under the law are best addressed to legal professionals examining your specific written documents and factual and legal situations. Sauer & Sauer, concentrating its legal practice on only construction and surety law issues, sees as part of its mission the provision of information and education (both free) to the material suppliers, subcontractors, general contractors, owners and sureties it daily serves, which will hopefully assist them in the more successful conduct of their business. Articles and forms are available on a wide number of construction and surety subjects at www.sauerconstructionlaw.com.) We periodically send out 'Squibs' - short articles, such as this one - on various construction and surety law subjects. If you are not currently on the emailing list and would like to be (there is, after all, no accounting for taste), please contact us and we will, as Captain Picard would say, 'make it so'! As a point of information for those of you who are Starship Enterprise-captain-challenged, he's the one who has no hair and who speaks funny. When he was captain, the Enterprise was rated for speeds only up to Warp 11. Since those then-thought-of as halcyon days, this starship can now do Warp 14, all the while being ecologically friendly and LEED-rated, not polluting the atmosphere remotely as much as Cuba, China, Mexico or southern California. Or, for those not under the shadows of Route One, Chelsea. The only vehicles currently available with higher ratings are FIAT 500's, current Italian car offerings hardly ever to be confused with Lincoln Navigators. It is said that those who buy them without first insisting on test drives get truly exceptional gas mileage after the sale. And, they are very quiet, also. Inasmuch as they tend to live in the garage. Pretty much most of the time.)