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All Good Things Must Come to an End: Legal Issues in Construction Contract Termination

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I. INTRODUCTION

In the current economic climate, many construction projects face unforeseen challenges to completion. Participants in such projects would be well advised to consider the legal and economic implications of termination of the project and the related contracts. This paper will discuss some of the issues that may be encountered in that consideration. [1]

Under form contracts commonly used in the construction industry, termination is specifically addressed as a right of the Owner, and this right provides the Owner significant leverage in dealing with the Contractor, even if the termination provisions are not actually invoked. In working with each other through troubled projects, the Contractor and Owner must always bear in mind the consequences should the Owner exercise its termination rights. The right of *termination for cause*, a remedy that exists even if the contract is silent, may be limited by contract, and the contract may specify prerequisite conditions for this right to be invoked. In general, there must be some default on the part of the Contractor before the Owner becomes entitled to invoke its right to terminate the contract for cause. Consequently, the Owner is constrained from wrongfully invoking termination for cause by the risk of damages it would face in the event a court or arbitrator later decides that proper cause did not exist for the termination. On the other hand, standard form construction contracts generally also give the Owner the right of *termination for convenience*, which can be exercised without the necessity of showing any default by the Contractor, and can impose limitations on amounts recoverable by the Contractor for such termination. Termination for convenience is obviously a powerful tool available to the Owner in dealing with the Contractor and in managing the project.

The law regarding the right of a party to terminate a contract for cause, that is, in response to a default by the other party to the contract, is well settled in most jurisdictions, but more uncertainty attaches to the concept of termination for convenience. Where only one party has the right to terminate the contract, and may do so for the merest convenience, is the contract unenforceable as illusory? Is there any requirement that termination for the Owner's convenience be in good faith, or can a contract be terminated for convenience merely because the Owner has found another contractor who will finish the job at a lower price? Under what circumstances can a termination for cause be converted to a termination for convenience? What is the interplay between the Owner's right of termination for convenience, and the right of the Owner to issue deductive change orders? The following discussion will attempt to address such questions as they may arise in the context of contracts with the Federal Government, and in connection with private construction contracts.

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[1] The authors have used, with permission, this paper's general outline, many of the ideas expressed herein, and direct quotes, from the insightful paper by Michael F. Menicucci, *Termination for Convenience*, presented to the ABA Forum on the Construction Industry conference, Scottsdale Arizona, in October, 2006. Any errors are the authors' responsibility, not Mr. Menicucci's.

II. TERMINATION FOR CONVENIENCE

A. Purpose

The Owner's overriding purpose for any contract provision is to procure project completion on time and within budget. Many common contract clauses serve this purpose, including provisions that give the Owner the right to:

- inspect the work and refuse or reject it if not in compliance with the plans and specifications;
- approve the use of particular subcontractors or subcontractor personnel;
- specify additional work to be performed without invalidating the contract;
- accelerate the schedule if the Contractor is behind schedule;
- withhold payment upon discovery of defective work, even if the work was previously accepted; and
- withhold payment if liens are filed or threatened by subcontractors or suppliers.

However, unlike any of these common clauses, a termination for convenience clause allows the Owner to end the Contractor's right to complete, or even continue, the work. This extraordinary remedy is so favorable to the Owner that the Federal Acquisition Regulations ("FAR") require that all federal contracts include provisions giving the Government the right to terminate the contract if the Contracting Officer determines that termination is "in the Government's best interest."[2]

Another, more mutually beneficial purpose may be served by termination for convenience. Where the contracting parties' relationship has become insupportable because of a conflict of personalities, or it has become apparent that the Contractor cannot perform the remaining work without an unbearable loss, termination for convenience can allow the parties to achieve a mutual parting of the ways without the cost and uncertainty of litigation or arbitration.

B. Constructive Termination for Convenience and the Conversion Clause

i. Government Contracts

In a "wrongful" default termination case, the non-breaching party, typically the Contractor, is entitled to be made whole and restored to the position it would have been in had the contract been performed. For a wrongfully terminated Contractor, this usually means recovery of expectancy damages, measured by the Contractor's anticipated profit on the entire project, regardless of the stage of project completion at the time of termination. The Government can avoid this consequence simply by declaring a termination for convenience, thus limiting a contractor's right to recovery to the costs of work completed at the time of termination[3] (together with certain specified costs of termination).[4] But what if, instead of

[2] 48 CFR 49.502; 48 CFR 52.249-2

[3] *See Krygoski Construction Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996).

[4] 48 CFR 52.249-2

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