

CDR.04

You're Fired!

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What seemed to be a good idea at the time is no longer. The owner has chosen to stop construction and terminate the contractor. Most construction contracts have termination for convenience and default termination clauses which have different rights and remedies.

We have all heard about disputes over a wrongful termination, but what makes a termination righteous and when does the surety get involved? Further, we have all read contract clauses similar to the following: In such event, the contractor shall be paid for work executed and reasonable expenses sustained, plus a reasonable profit. But what is reasonable and what is work executed?

According to Webster's Dictionary, termination means a coming to an end of a contract period; or the act of ending something; such as the termination of the agreement. In construction contracting there are three types of terminations:

1. Termination by owner for convenience.
2. Termination by owner for cause.
3. Termination by the contractor.

The Federal Acquisition Regulation (FAR) part 49 contains the following termination clause:

52.249-6 Termination (Cost-Reimbursement) (Sep 1996)

(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, or the contractor defaults in performing this contract and fails to cure the default within 10 days (unless extended by the contracting officer) after receiving a notice specifying the default. Default includes failure to make progress in the work so as to endanger performance.*

(b) *The contracting officer shall terminate by delivering to the contractor a Notice of Termination specifying whether termination is for default of the contractor or for convenience of the government, the extent of termination, and the effective date. If, after termination for default, it is determined that the contractor was not in default or that the contractor's failure to perform or to make progress in performance is due to causes beyond the control and without the fault or negligence of the contractor as set forth in the Excusable Delays clause, the rights and obligations of the*

parties will be the same as if the termination was for the convenience of the government" [2].

Similar termination clauses have been incorporated into the American Institute of Architects General Conditions of Contract and often are the basis for state and local public contracts.

TERMINATION BY OWNER FOR CONVENIENCE

If a contractor is not terminated for default he is terminated for convenience. Reasons for termination for convenience are:

- Project is no longer financially viable.
- Permit delays—unable to obtain proper building or environmental permitting.
- Changes of conditions—subsoil conditions require a change in foundation design which makes the project impossible to build.
- Buyer's remorse—just don't want to proceed anymore.

Basically any reason that is not a default reason and is for the owner's convenience. Under a default termination, federal case law indicates that the government or the owner must prove that the termination for default was proper.

TERMINATION BY OWNER FOR CAUSE

Public construction contracts typically state that a Contractor may be terminated for default for the following:

- Anticipatory breach by contract; i.e., the contractor threatens to abandon work if a change order is not appropriate.
- Failure to comply with contractual provisions.
- Lack of construction progress; refusal or failure to prosecute the work.
- Performing substandard, defective or nonconforming work.
- Failure to reimburse subcontractors and suppliers.
- Violation of laws or ordinances.

The government or owner is required to fulfill all contractual notice provisions prior to terminating the contractor for default. This includes giving the contractor the opportunity to cure the alleged material breach. The government or owner's failure to supply the proper default notification and opportunity to cure may render a valid default termination into a termination for convenience. FAR regulations also require that the contracting officer must permit the contractor an opportunity to present his case as to why the contract should not be terminated.

The burden of proof is on the government or owner to demonstrate and document that the contractor was in default at the time of the termination, and the contracting officer used reasonable judgment in his decision to terminate. The veracity of the proof is often the issue of a wrongful termination claim.

The contracting officer must determine that the contractor is in technical default and material breach. The contractor may be excused from the consequences of such default as a result of the government or the owner's action if the contractor's construction progress is significantly delayed and the delay was the result of the design provided by the government or owner being incomplete and erroneous. The contractor's delay is excusable and not grounds for default. The standard government delay clause provides that a delay is excusable and does not provide a valid termination for default if the delay is "beyond the control and without fault or negligence" of the contractor. The contract disputes over time and money issues are not resolved by default termination.

In a multi-prime state, such as Ohio, the general contractor's delays may be caused by one or more of the other multi-prime contractors who are beyond his control. In addition to excusable actions, a contractor's defense against default is alleging that their work is in general compliance or fulfills substantial performance of the contract and is not a material breach of the contract. Construction work such as incomplete punch lists or other incomplete items are not generally grounds for default termination of the contract.

SURETY

The contractor's performance in most public construction projects is "assured" by a surety bond. "Assured" is a guarantee or pledge "to make secure on contract". The 1935 Miller Act, 40 U.S.C. §§ 270a-270f, established that all federal construction contracts performed in the United States must require the contractor to furnish a performance bond in an amount satisfactory to the contracting officer; a payment bond in a penal sum of up to \$2.5 million, and bid guarantees.

In the US Federal Acquisition Streamlining Act of 1994, Congress made the Miller Act inapplicable to contracts under \$100,000. The Construction Industry Payment Protection Act of 1999 requires that the bond be equal to the performance bond amount, usually the total amount due under the contract, affording more protection to subcontractors and suppliers. Further, the Act prohibits prime contractors from requiring their subcontractors to waive their payment bond rights in the subcontract documents. These statutory requirements are implemented in FAR part 28, bonds and insurance. [2]

After the owner terminates the contractor for cause, he looks for the surety to complete the project. To understand the consequences of default, let us first review the role of a surety in a construction project. There are three parties to a surety bond:

- The surety, which may be an insurance company but is hopefully a company with sufficient financial assets, insures that the contractor will complete its performance. The surety company must be certified as a qualified surety by the US Department of Treasury. A current list of certified companies can be found at www.fms.treas.gov/c570/c570.html. In addition, most states require sureties to be licensed by the state.
- The obligee is the owner or the government and is assured by the surety.
- The principal is the contractor who submits the bond.

The contract bond normally assures the obligee of two potential risks:

- If the contractor fails to execute the contract, the surety will pay the owner the difference between the contractor's bid and the next lowest bid up to a limit of usually 10 percent of the contractor's bid amount. This assures the owner of the bid process.
- After the execution of the contract, if the contractor defaults in the performance of the contract with the owner, the surety will be liable up to the amount of the bond for the completion of the contract.

The amount of the bond is referred to as the penal sum or penalty amount. Usually it is the upward limit of liability on the bond. The surety is also obligated to pay suppliers and subcontractors of the contractor for furnished material, labor and equipment on the project. The surety is paid a premium or fee by the contractor which is usually a percentage of the contract amount. This percentage varies based on the surety's evaluation of the contractor's previous history and financial strength. One common misconception is that a surety works like an insurance policy. The mistaken belief is that if the contract goes bad, the surety pays the contractor and the premiums are increased on subsequent projects. If the surety is required to pay any claim from the owner or subcontractors, the surety will look to the Contractor or the contractor's assets for reimbursement.

If an owner terminates the contractor for cause, it will either pursue a claim against the surety to complete the work under the contract or pay the owner for the cost of completion including his administration or construction management costs. When the surety promised to insure the contractor's performance, it acquired subrogation rights. Subrogation means the right to collect a legal debt that was originally owed to someone else. When the surety offers to take over the contract for its contractor it rightfully wants to be paid all monies to which the principal is required to pay. Ordinarily, this is the balance owed under the contract at the time of termination, less offsets for delays and other damages caused by the contractor.

ALTERNATIVES TO DEFAULT TERMINATION

In general, a default termination adds costs to both the owner and the contractor and payment of those cost will be disputed. The work stoppage, remobilization and relet process add costs to the project. It is very important for both the owners and contractors to view default termination in the most serious manner due to the magnitude of the damage to either organization. Not only could the consequences of such action be terminal to a contractor but the wrongful termination or even the unwise termination can have a significant impact on the owner or government. The act of default termination should in all cases be considered as the last alternative. There are many potential alternatives to default termination. Most contracts include clauses which allow the owner to supplement the contractor's workforce in order to increase the progress of the project to contract requirements. Supplementing a contractor's workforce instead of terminating eliminates the project lost time associated with the termination process. The supplemental workforce can include project control specialists such as schedulers, field coordinators and material expeditors. Another possible remedy is deductive change orders in which a portion of the work scope is removed from the contractor's scope of work but allowing him to continue on the immediate work to keep the job moving while the problem is being corrected. Some owners have been successful in requesting the surety to financially support a troubled contractor during the completion of his work.

Whether a termination is for convenience or for default, the contractor should respond with immediate action as directed and develop a termination plan. Upon notification of termination it is imperative for the contractor to stop all work in accordance with the contract provisions and to immediately document at least the following:

- The status of all work completed to date;
- The status of all subcontractors;
- The status of all material suppliers as of the date of termination;
- All costs associated with the termination (open a separate charge number);
- All work performed with a photographic/video record;
- An as-built schedule;
- A final pay application;
- Any costs associated with permanent site safety;
- Labor reassignment costs;
- Material cancellation;
- General and administrative expenses associated with termination;
- Idle facility costs as a result of termination;
- Settlements with subcontractors;
- Accounting, legal, clerical and similar costs necessary as a result of termination;
- Mitigation actions taken to reduce the costs of termination; and
- The impact of reassigned personnel on other projects.

An example of a guideline for reimbursable termination expenses is the following excerpt taken from the FAA (Federal Aviation Administration Acquisition System Tool Set) Pricing Manual:

17.3.7 Settlement Expenses

"Settlement expenses include accounting, legal, clerical and similar costs necessary for preparation of the settlement proposal. Additionally, settlement costs include costs for storage, transportation, protection, and disposition of property acquired or produced for the contract. Indirect costs incurred for the areas above are allowable. Overhead costs are limited to payroll taxes, fringe benefits, occupancy costs, and immediate supervision costs. A separate account for settlement expenses should be established if costs are significant. Severance payments are specifically excluded from settlement expenses.

Many issues may arise during the analysis of settlement expenses. Initially, determination of whether the costs were in fact necessary is required. Other issues which may come up are as follows:

- *Post-termination costs such as relocation, temporary assignment, and retraining are sometimes allowable depending on the situation. Generally, it must be shown that the actions were a direct result of the termination and were cost-effective; and*
- *Unabsorbed overhead is generally unallowable in complete terminations. Some precedent has been set for reimbursement for partial terminations. Although the Government and courts have been adamant in not paying for unabsorbed overhead, this remains a major area of contention with the contractor.*

17.3.8 Subcontractor Claims

Subcontractor claims are submitted to the government by the prime contractor for approval and ratification before the prime contractor includes the costs in its settlement proposal. The prime contractor is responsible for negotiating a settlement with the subcontractor. Often, the subcontractor and the prime include the same type of costs in their proposals. Since some of the issues are the same the prime contractor wants to negotiate with the government, a conflict of interest is often created. The government must be careful to ensure consistency when determining allowability and reasonableness. Additionally, as is often the case, if the subcontractor elects not to allow the prime contractor to see their confidential/proprietary data the government has to mediate between the subcontractor and the prime contractor. It is in the government's best interest to closely monitor any negotiations with the subcontractors.

17.3.9 Profit/Fee Adjustment/Loss

Loss Adjustment (Fixed-Price)

Termination is not intended to be a means of recovering from a loss situation; therefore, in a fixed-price contract an adjustment should be made if it is apparent that there would have been a loss. An estimation of costs to completion based on costs incurred is necessary to assess if a loss would have been incurred by the contractor had the entire contract been completed. A loss applies to

an adjustment of the price paid for acceptable finished items, not to the settlement costs. If the settlement is on an inventory basis the contractor shall not be paid more than the total of the following, less all credits, unliquidated advances and progress payments:

- The amount negotiated or determined for settlement expenses.
- The contract price, as adjusted for acceptable completed end-items.
- The remainder of the settlement amount reduced by total contract price divided by the sum of total costs incurred before termination and the estimate to complete.

When adjusting for a loss, the government has the burden of proving that a loss adjustment is appropriate. Loss adjustments are also subject to the following conditions: 1.) if the increase in costs is due to actions made by the government, no loss adjustment should be made and 2.) if the contractor is entitled to a price adjustment, a loss adjustment may be inappropriate and/or subject to changes in price (Admin. of Gov't Contracts, GWU: 866-867).

Profit/Fee Adjustment

Because only a portion of the contract will have been completed at the time of termination, the profit/fee as originally negotiated may not be appropriate. The profit/fee level may need to be adjusted to reflect the percentage of the contract's completion. Profit/fee should only be adjusted if at termination the contractor is in a profit situation. The termination clause of the contract may state a basis for profit restriction. If so, this clause should be used as a guide in determining profit. Further considerations in adjusting profit/fee differ based on the type of contract.

Fixed-price Contracts

The contractor has the burden of proof in adjusting profit on a fixed price contract. Using FAR 49.2 as a guideline, the following nine criteria may be helpful for determining profit:

1. Extent and difficulty of the work done as compared to total work required by the contract.
2. Engineering work, production scheduling, planning, technical study and supervision, and other necessary services.
3. Efficiency with regard to (a) attainment of quantity and quality production, (b) reduction of costs, (c) economic use of materials, facilities, and manpower, and (d) disposition of termination inventory.
4. Amount and source of capital and extent of risk assumed.
5. Inventive and developmental contributions, and cooperation with the government and other contractors in supplying technical assistance.
6. Character of the business, including the source and nature of materials and the complexity of manufacturing techniques.
7. The rate of profit the contractor would have earned.
8. The rate of profit both parties contemplated when the contract was negotiated.
9. Character and difficulty of subcontracting.

These guidelines are somewhat subjective and require the use of sound judgment...." [3]

The FAR Price Manual clearly suggests that reimbursable costs are not necessarily all costs incurred prior to the termination and that termination is not intended to allow contractors to recover previous losses. The amount paid for work executed is defined by the government as contract price for completed items and proportions of the contract price for incomplete work based on the summation of cost incurred and cost to complete.

As discussed in the guideline, the collection of unabsorbed overhead or underabsorbed overhead is a difficult process without a documented causation liability damage linkage. The contractor's ability to quantify overhead costs as a result of the termination increases the probability of a favorable settlement to the contractor. The FAR regulations are unique and are not an extension of common law. In a similar fashion, lost profit claims have not been viewed favorably by the courts. However, in most cases the contractor is entitled to a reasonable profit for the work performed. The determination of a reasonable profit is subject to multiple standards such as:

- Type of contract,
- Type of risk associate with that contract,
- Special conditions associated with that contract which separates it from the norm.

Termination by the Contractor

So far we have only been discussing termination by the owner. The AIA Document A201-1997 provides the following provision that the Contractor may terminate the contract.

14.1.1—The contractor may terminate the contract if the work is stopped for a period of 30 consecutive days through no act or fault of the contractor or a subcontractor, sub-subcontractor or their agents or employees or any other persons or entities performing portions of the work under direct or indirect contract with the contractor, for any of the following reasons:

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;
3. Because the architect has not issued a Certificate for Payment and has not notified the contractor of the reason for withholding certification as provided in subparagraph 9.4.1 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 as required by subparagraph 2.2.1.

14.1.2—The contractor may terminate the contract if, through no act or fault of the contractor or a subcontractor, sub-subcontractor or their agents or employees or any other persons or entities performing portions of the work under direct or indirect

contract with the contractor, repeated suspensions, delays or interruptions of the entire work by the owner as described in paragraph 14.3 constitute in the aggregate more than 100 percent of the total number of days scheduled for completion, or 120 days in any 365-day period, whichever is less. [1].

The contractor's decision to terminate the contract shifts the burden of proof to the contractor for notice and documentation of the alleged owner inactions.

The rights and remedies associated with termination depend largely upon the relevant termination provisions as set forth in the contract. As with many issues, the interpretation of the clause and the significance of the issues are subject to opinion. A percentage of construction contracts will be terminated every year. This decision should be made however, only as a last resort.

Termination is always costly, both to owners and contractors alike.

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