

Outside Counsel

Expert Analysis

Termination for Convenience Of Construction Contracts

Consider this hypothetical scenario. An owner-developer commences construction of a 30-story hi-rise residential building toward the end of the real estate boom. As the core and shell of the building is close to completion, the owner realizes that the boom is over and it will be unable to sell the apartments at a profit for a least two to three years. When the building is fully enclosed, protected from the elements and approximately 60 percent complete, the owner terminates the contract “for convenience.” The contractor is paid for all work performed to date, demobilization costs, subcontractor close-out costs, and 60 percent of its profit. Three years later, the owner-developer is ready to re-commence construction and discovers that a substantial number of structural steel reinforcing members required to be imbedded in the building’s columns have been omitted.

This article will examine the very limited question of whether an owner can recover from the contractor the cost of remedying the defective work discovered after a “termination for convenience.”

The Common Law Doctrine

Under the common law doctrine of freedom to contract, parties have been free to confer a contractual right upon one or both parties to terminate the contract “without cause,” popularly known as a “termination for convenience.” Such contractual provisions first arose at the end of the Civil War to allow the federal government to wind down military procurement and settle with the contractor for the portion of the work already performed.

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In a 1982 decision, the Court of Claims wrote: “It originated in the reasonable recognition that continuing with wartime contracts after the war was over clearly was against the public interest. Where the circumstances of the contract had changed so dramatically, the government had to have the power to halt the contractor’s

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performance and settle.” *Torncello v. United States*, 681 F.2d 756, 764 (Ct. Cl. 1982).

During World Wars I and II, termination for convenience clauses were used extensively in governmental procurement contracts and have thereafter been standard in peace time in both military and non-military contracts for the government.

Since World War II, termination for convenience clauses have been universally used in private construction contracts and since 1997 appear in most form contracts published by the American Institute of Architects (AIA) and other industry groups.

For example, the current version of the AIA termination for convenience provisions provide, in part:

§14.4 Termination By The Owner For Convenience.

§14.4.1 The owner may, at any time, terminate the Contract for the owner’s convenience and without cause.

Section 14.4.3 In 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.

Termination for convenience provisions usually provide for compensation to the contractor for all work performed and fee earned to the date of termination, demobilization costs and costs of closing out subcontracts. Although the current AIA provision provides for recovery for anticipated (unearned) profit on the unperformed portion of the work, typically this provision is deleted or modified in negotiation so that no recovery is allowed for anticipated profit on unperformed work or for any type of consequential damages. However, occasionally the parties will agree to a provision for an additional “break-up” fee depending upon what percentage of completion of the work has been achieved.

When Is It Appropriate?

Whether a termination for convenience is appropriate in a particular circumstance is not always obvious. The owner must make a rational business judgment with many questions to consider:

1. What stage of completion is the project?
2. Is there reason to terminate for cause?
3. If it is a close question as to whether proper grounds exist to terminate for cause, will a termination for cause result in expensive and time-consuming litigation exposing the owner

to damages for a wrongful termination?

4. How will a termination affect subsequent completion of the project?

However, another less-obvious question which should factor into the owner's decision of whether to terminate for cause or for convenience is the extent to which already-completed work contains defects requiring remedial work for which the owner may want to recover from the contractor. While the owner's costs of remedying the contractor's defective work are recoverable as damages in a termination for cause, the law is unsettled as to whether such costs are recoverable in a termination for convenience absent clear contractual provisions granting such recovery. Reported decisions addressing the owner's right to recover for defective work following a termination for convenience in the absence of specific contractual language have been few and inconsistent.

Board of Contract Appeals

Since termination for convenience clauses first originated in federal government contracts, it logically follows that most of the reported decisions on this question come from the federal Board of Contract Appeals (BCA). BCA and other decisions have repeatedly held that where the parties' contract expressly allows recovery for defective work after a termination for convenience or provides that the contractor's corrective obligations survive such a termination, that agreement will be enforced. *United States for the Benefit and Use of EPC Corporation v. Travelers Casualty & Surety Company of America*, 423 F.Supp. 1016, 1027 fn. 9 (D. Ariz. 2006) (the "express agreement of the parties takes precedence"); *Aydin Corporation*, 89-3 BCA P 22044, Energy Board of Contract Appeals, No. 355-5-86, 1989 WL 74785 (EBCA 1989); *New York Shipbuilding Co.*, Armed Services Board of Contract Appeals No. 15443 (1972), 1972 ASBCA Lexis 111 at 17-18.

For example, one court recently held that where the parties' contract provided that the contractor's warranties and obligations survive termination (not specifically limited to terminations for cause), the contractor remained liable for corrective costs following a termination for convenience. *Layton Construction Co. Inc. v. Barclays Capital Real Estate Inc.*, No. 2009 CV 606, slip op. (District Court, Eagle County, Colo., Sept. 15, 2010). Although the contract was terminated prior to substantial completion and the contractor's primary warranty did not contractually arise until substantial completion, the court found other warranties and corrective work obligations existing from the commencement

of the work which survived termination.

The court additionally held that the termination for convenience was not a waiver of any claims for corrective work which already may have existed prior to the date of termination. See, *Armour and Company v. Nard*, 463 F.2d 8, 10 (8th Cir. 1972), *Chicago Titles Ins. Co. v. Title Consultants Inc.*, 472 So.2d 1380 (Fla. App. 1985).

In the absence of express contractual language, two lines of federal BCA decisions have evolved. One line of cases holds that while the owner may not affirmatively recover from the contractor the costs of correcting defective work, the owner may set off such costs against the contractor's recovery for work costs completed through the date of the termination to the extent that the defective work resulted from the contractor's "gross disregard" of its contractual obligations. The other line of cases calls into question this rule prohibiting direct recovery, declining to follow it while not expressly overruling it.

A question which should factor into the owner's decision of whether to terminate for cause or for convenience is the extent to which already-completed work contains defects requiring remedial work for which the owner may want to recover from the contractor.

The BCA cases barring direct recovery by the owner and limiting an offset to the contractor's gross disregard of its contract obligations are epitomized by *New York Shipbuilding Co.*, ASBCA No. 15443 (1972), 1972 ASBCA LEXIS 111. The board relied upon earlier BCA decisions denying direct recovery for costs to correct defective work after a termination for convenience, rationalizing that a contractor who has been terminated for convenience did not have prior notice of defective work and therefore did not have the opportunity to perform its own corrective work. Thus, reasoned the board, it would be unfair to charge the contractor with the owner's (presumably higher) costs to correct any defects in the contractor's work.

The board further stated, however, the contractor should not benefit from its own "lack of care, fault or folly," and that the contractor's recovery from the owner for work performed through the date of the termination would be reduced by the cost of any such work which was defective to the extent that the deficiencies stemmed from the contractor's "gross disregard...

of its contractual obligations." This exception was based upon the earlier BCA opinion in *Caskel Forge Inc.*, ASBCA No. 7638, 1962 BCA P3318, and has been restated in later opinions which adopted the overall approach of *New York Shipbuilding*. See, e.g., *Best Foam Fabricators v. United States*, 38 Fed.3d 627, 640-641 (Fed. Cl. 1997), *Morton-Thiokol Inc.*, 90-3 BCA P 23207, ASBCA No. 32629 (1990).

Therefore, under the rule established by this line of cases, an owner who terminates a contractor for convenience may only recover the cost of correcting defective work if the owner can show that the defects resulted from the contractor's gross disregard of its contractual obligations, and even then only as an offset against the amounts otherwise due the contractor for unpaid work performed up to the date of termination.

In a further enigmatic remark, however, the board in *New York Shipbuilding* also stated that "our decision...does not affect the inclusion [as a setoff against the amount due contractor] of [contractor's] estimated costs...for correcting alleged deficiencies...had it not been terminated," indicating that even if the defects were not the result of gross disregard of the contractor's obligations, the owner could still offset the contractor's (not the owner's) estimated cost to correct that work under the theory that the contractor would have had to correct its work as part of the completion of its contract had it not been terminated. No further BCA opinions appear to have commented on this particular language, although it would seem to present the most equitable solution to the dilemma.

Indeed, while some later BCA opinions have followed the general rule stated in *New York Shipbuilding*, other boards and courts have expressly declined to follow its prohibition against direct recovery for defective work. On an appeal from a BCA case, the U.S. Court of Appeals for the Federal Circuit expressly declined to follow this rule in *Lisbon Contractors Inc.*, 828 F.2d 759 (Fed. Cir. 1987), instead denying the owner recovery for defective work costs after a termination for convenience on unrelated grounds of failure to prove the amounts at issue.

In *Air Cool Inc.*, 88-1 BCA P 20399, ASBCA No. 32838, 1987 WL 46144 (1987), the BCA itself "questioned whether [the *New York Shipbuilding*] rule will continue to be followed," and further stated in *Aydin Corporation*, supra, that "the continued applicability of *New York Shipbuilding* and its forerunners is seriously in doubt" while "declin[ing] to mechanically follow *New York Shipbuilding*." These two seemingly

contradictory lines of federal decisions have not been reconciled, and the current viability of the principles set forth in *New York Shipbuilding* is uncertain.

New York Law

Although New York state law is also sparse on this issue, it is clearer than federal law and favors the terminated contractor. In *Tishman Construction Corporation Inc. v. City of New York*, 228 A.D.2d 292, 642 N.Y.S.2d 589 (1st Dept. 1996), the city terminated Tishman for convenience and then attempted to recover the costs of correcting defective work as counterclaims against Tishman's claim for termination costs, citing (i) the contract's generalized boilerplate "all defenses reserved" and "no waiver" clauses and (ii) the overwhelming complexity and implications of a termination for cause as reasons why its claims should be allowed in spite of the city's failure to cite cause in terminating the contracts.

Relying on the earlier Appellate Division opinion in *Fruin-Colnon Corp. v. Niagara Frontier Transportation Authority*, 180 A.D.2d 222, 585 N.Y.S.2d 248 (4th Dept. 1992) (which in turn cited no precedent for its denial of an owner's claim for remedial work costs against a contractor deemed to have been terminated for convenience), the court rejected the city's arguments and held that the city could not counterclaim for the cost of curing any defective work. The Court did leave open the possibility of recovery by the city "to the extent that the city can show that overpayments were made [to the contractor] on a theory of fraud or mistake, rather than under the terms of the contract;" however, this is an extremely difficult burden of proof to establish and is more contractor-favorable than the federal BCA "gross disregard of contractual obligation" exception.

The difficulty in meeting the *Tishman* exception is underscored by *Paragon Restoration Group Inc. v. Cambridge Square Condominiums*, 42 A.D.3d 905, 839 N.Y.S.2d 658 (4th Dept. 2007), where the Appellate Division dismissed an owner's defective work counterclaims following a termination for convenience, relying upon the *Tishman* opinion. The court further dismissed any fraud or tort-based defective work claims (apparently interposed by the owner in an attempt to make use of the *Tishman* exception), stating that New York law is clear that separate fraud or tort claims are generally not actionable when they arise solely from contractual obligations and not from independent legal duties arising outside of the contract.

The *Tishman* court further muddled things, however, by concluding its opinion with the enigmatic statement that "nothing in [the lower Court's] decision affects the city's defenses

based on breach of contract principles." This unexplained comment has not been addressed in any further decision and might leave open the possibility of a broader defensive offset against a contractor's claims for unpaid work through the date of termination.

The Court of Appeals

New York's highest Court, the Court of Appeals, has only addressed the issue peripherally and that was long before the Appellate Division's decision in *Tishman v. City*. In *Arc Electrical Construction Co. Inc. v. George A. Fuller Company Inc.*, 24 N.Y.2d 99, 247 N.E.2d 111, 299 N.Y.S.2d 129 (1969), the Court of Appeals held that a contractor which had been terminated for convenience and was therefore denied notice of defective work and the opportunity to cure the defects was entitled to be paid for all work actually performed; however, the Court further stated that "if there were any deficiencies in performance, they would merely diminish the amount to which [the contractor] would be entitled...."

This holding would appear to allow the owner to offset the cost of curing defective work against the contractor's post-termination recovery but would not allow a direct affirmative recovery; moreover, it is not clear whether the Court intended such an offset to be based upon the cost to the owner to correct the defects or the (presumably lower) estimated cost to the contractor to correct those defects. In view of the Court's recognition of the unfairness of denying the contractor the opportunity to perform its own corrective work, it is logical to assume the Court intended a reduction based upon the estimated cost to the contractor to correct its own work had it not been terminated. The obvious inconsistencies between this case and the later Appellate Division opinion in *Tishman v. City* have not been addressed by the New York Courts.

In view of the uncertain nature of existing law, the increasing use of termination for convenience clauses in private contracts and the recent lessons regarding the vagaries of the real estate market, it would seem that this issue is ripe for more definitive treatment by the courts on both a federal and New York state level. This need is further exemplified by the recent decision from the Supreme Court, Kings County, in *400 15th Street, LLC v. Promo-Pro, Ltd.*, Index No. 20651/2006 (Sept. 10, 2010), wherein the court allowed the after-the-fact conversion of a termination for convenience into a termination for cause, thus suggesting a way around the *Tishman* rule in order for an owner to recover for defective work after first exercising its contractual right to terminate for convenience.

A logical compromise rule which is suggested by some of the cases would be to allow an owner that terminates a contract for convenience (thereby denying the contractor the opportunity to self-correct any defective work and, perhaps more importantly, probably denying the contractor the opportunity to compel its subcontractors to perform that work) to affirmatively recover directly from the contractor only the estimated costs which the contractor (or its subcontractors) would have incurred in correcting the work had the contract not been terminated (as opposed to the owner's presumably higher cost to perform the same work).

Such a result would prevent the contractor from reaping a windfall for not properly performing its work and would lessen the burden placed on the owner to correct the work, but would not reward the owner for circumventing the often difficult (and costly) process of establishing through litigation a basis for a termination for cause and avoiding the risk of a wrongful termination finding (as the city attempted to do in the *Tishman* case). Since the contractor would have had to incur some cost to correct its defective work had it not been terminated, it would seem a fair and reasonable trade-off to charge the contractor with those costs, but to deny the owner its own presumably much greater corrective costs, in exchange for the owner's avoidance of the costs and risks of a termination for cause.

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