

AMERICAN BAR ASSOCIATION FORUM ON CONSTRUCTION INDUSTRY  
FUNDAMENTALS OF CONSTRUCTION LAW OF THE  
CONSTRUCTION INDUSTRY

DEFAULT TERMINATION

Prepared By:  
Gregory L. Cashion  
Smith & Cashion, PLC  
SunTrust Center, Suite 1200  
424 Church Street  
Nashville, Tennessee 37219  
(615) 742-8555  
(615) 742-8556 Facsimile  
e-mail: [gcashion@smithcashion.com](mailto:gcashion@smithcashion.com)

## **DEFAULT TERMINATION**

Termination for default is one of the most serious provisions in a construction contract. Before advising about a default termination, an attorney must be familiar with the entire contract, examine particularly any clauses relating to termination, examine the clauses relating to any dispute underlying the default, be familiar with the facts which justify a termination and evaluate how the dispute between the owner, contractor and surety will be adjudicated.

The discussion of this paper focuses primarily on a default termination by the owner. The grounds for termination by the contractor are less prevalent and less complicated. Most standard contract documents require the contractor to keep working as instructed during the pendency of any dispute, while giving the contractor the right to make a claim for a price increase.<sup>1</sup> Rarely does anything but non payment justify termination by a contractor.

The greatest risk of either the owner or the contractor in terminating a contract is that the termination could be determined by a court or arbitration panel to be wrongful. If the termination is proved to be wrongful, then the party terminating the contract not only fails to collect its additional funds spent to complete the project, but must also pay the wrongfully terminated party its contract payments through the date of termination and potentially the loss of profit on the work not performed.

### **I. GROUNDS FOR TERMINATION BY AN OWNER**

The contractor has many obligations under a typical construction contract. Whether an event of default exists must, of course, be determined with reference to the

---

<sup>1</sup> See, for example, AIA Document A201-1997, § 4.3.3.

contract itself. Most construction contracts, however, define at least the following acts or omissions by the contractor as events of default which entitle the owner, at its option, to terminate:

**A. Sub-Standard, Defective or Nonconforming Work**

The contractor is obligated to perform its work in a good and workmanlike manner.<sup>2</sup> Moreover, the contract will typically provide express warranties regarding the quality of the work and the materials used. In AIA Document A201, for example, the Contractor warrants the following:

...materials and equipment furnished under the Contract will be of good quality and new unless otherwise required or permitted by the Contract Documents, that the Work will be free from defects not inherent in the quality required or permitted, and that the Work will conform to the requirements of the Contract Documents. Work not conforming to these requirements, including substitutions not properly approved and authorized may be considered defective.<sup>3</sup>

The owner itself may have the authority to reject nonconforming or defective work, or the contract may provide different or additional mechanisms by which such work may be rejected. In AIA Document A201, the architect has the authority to reject work that does not conform to the contract documents.<sup>4</sup> The performance of work by the contractor which is rejected by the architect is a ground for termination of the contract. The owner would have the burden of proving that the defective work is of a material nature to the project and would justify termination of the contract.

---

<sup>2</sup> See, e.g., *Tharpe v. G.E. Moore Company*, 174 S.E.2d 397, 399 (SC 1970); *Weck v. A:M Sunrise Construction Company*, 184 N.E.2d 728, 734 (Ill. App. 1962).

<sup>3</sup> AIA Document A201-1997, § 3.5.1.

<sup>4</sup> *Id.* at 11, § 4.2.6.

## **B. Failure to Pay Subcontractors and Suppliers**

The failure of the contractor to pay its subcontractors and suppliers will expose the owner to mechanic's liens. Most contracts expressly obligate the contractor to "stay current" with all of its subcontractors and suppliers. AIA Document A201 provides that the contractor:

...warrants that upon submittal of an Application for Payment all Work for which Certificates of Payments have been previously issued and payments received from the Owner shall, to the best of the Contractor's knowledge, information and belief, be free and clear of liens, claims, security interests or encumbrances favor of the Contractor, Subcontractors, material suppliers, or other persons or entities making a claim by reason of having provided labor, materials and equipment relating to the Work.<sup>5</sup>

The owner may discover the contractor's failure to pay its subcontractors and suppliers through the filing of mechanic's liens against the project, or through less formal communications from the subcontractors or suppliers (directly or through intermediaries, such as the architect.) The contractor's failure in this regard is a matter to be taken seriously by the owner, and should be investigated as promptly as circumstances allow. The failure of the contractor to pay subcontractors and suppliers is generally a ground for termination of the contract.<sup>6</sup>

## **C. Failure to Pursue Work Diligently**

The contractor has an obligation to pursue its work under the contract in a diligent fashion. In AIA Document A201, the contractor is required to prepare and update a construction schedule which provides for the "expeditious and practicable execution of

---

<sup>5</sup> Id. at 16, § 9.3.3.

<sup>6</sup> See, e.g., Id., § 14.2.1.2.

the Work,” and must “perform the Work in general accordance with the most recent schedules.”<sup>7</sup> The contractor’s failure to pursue the completion of the work in reasonable compliance with the schedule will generally constitute an event of default justifying termination by the owner.<sup>8</sup> The owner should be careful to distinguish between isolated or insignificant deviations from the schedule and serious, ongoing problems with the progress of the work. In that spirit, for example, AIA Document A201 provides that the owner may terminate the contract if the contractor “persistently or repeatedly refuses or fails to supply enough properly skilled workers or proper materials” for the project.<sup>9</sup>

**D. Violation of Laws, Ordinances, Etc.**

Construction contracts commonly allow the owner to terminate if the contractor defaults by violating laws or ordinances that apply to the owner, the contractor and/or the project. As with the contractor’s failure to adhere to the schedule as discussed above, the owner will not be justified in treating an isolated incident as a default justifying termination. Rather, as reflected in AIA Document A201, the owner can terminate if the contractor “persistently disregards laws, ordinances, or rules, regulations and orders of a public authority having jurisdiction.”<sup>10</sup>

There are, of course, many laws which a contractor could violate which might give rise to the owner’s right to terminate. Some examples include failure to pay sales, use or payroll taxes applicable to the work under the contract<sup>11</sup>; failure to obtain permits

---

<sup>7</sup> Id., §§ 3.10.1, 3.10.3.

<sup>8</sup> See, e.g., *Black Lake Pipe Line Co. v. Union Construction Co.*, 538 S.W.2d 80 (Tex. 1976).

<sup>9</sup> AIA Document A201-1997, §14.2.1.1.

<sup>10</sup> Id., §14.2.1.3.

<sup>11</sup> See, e.g., Id., 3.6.1.

and license required for the work, assuming that the contract calls for the contractor to do so<sup>12</sup>; and failure to observe safety laws, ordinances and regulations.<sup>13</sup>

#### **E. Other Substantial Breach of Contract – Examples**

Most construction contracts should and do contain general provisions which permit the owner to terminate if the contractor commits a material breach of the contract. What constitutes a material breach will depend, of course, on the provisions of the contract. Where the contract is silent or ambiguous, the parties' intent will be inferred by the court, as an question of fact, from extrinsic evidence of the circumstances.<sup>14</sup>

#### **F. Certification by Architect**

Depending on the type of default by the contractor and the type of contract drafted by the parties, the architect may have a role in establishing the existence of a default which will permit the owner to terminate the contract. The AIA construction contracts provide a high level of involvement for the architect in any effort by the owner to terminate for default. AIA Document A201 provides that when any of the enumerated grounds for default exist, the owner may terminate “upon certification by the Architect that sufficient cause exists to justify such action.”<sup>15</sup>

Whether the contract requires the architect to certify default or not, the owner should seek the opinion of the architect when considering terminating the contractor for default. In determining the reasonableness of the grounds alleged by the owner for default, the fact finder will place significant weight on the opinion of third parties, such as the architect.

---

<sup>12</sup> See, e.g., Id., 3.7.1.

<sup>13</sup> See, e.g., Id., §10.2.2.

<sup>14</sup> See., e.g., *Kuswa & Associates, Inc. v. Thibaut Construction Co.*, 463 So.2d 1264, 1266 (La. 1985).

<sup>15</sup> AIA Document A201-1997, §14.2.2.

## **II. NOTIFICATION OF DEFAULT**

### **A. Notice to the Contractor**

When the decision is made to terminate the contract because of default by the contractor, the owner must review the contract carefully to determine what notice must first be given to the contractor. Contract provisions which require notice to the contractor and an opportunity to cure are common. Under AIA Document A201, for example, the owner must give the contractor (and the surety, if any) seven (7) days' written notice before terminating the contract.<sup>16</sup> Depending on the type of default alleged, a contract may provide specific opportunities for the contractor to cure the default. In the case of defective or non-conforming work, for example, AIA Document A201 provides that if the contractor does not commence and continue the correction of the work within seven (7) days of the receipt of written notice from the owner, then

the Owner may after such seven-day period give the Contractor a second written notice to correct such deficiencies within a three-day period. If the Contractor within such three-day period after receipt of such second notice fails to commence and continue to correct any deficiencies, the Owner may, without prejudice to the other remedies the Owner may have correct such deficiencies.<sup>17</sup>

Thus, in the contract language quoted above, as in many construction contracts, the owner may not peremptorily terminate the contract by reason of an alleged breach by the contractor. In many instances, the contract will allow the contractor a reasonable opportunity to cure the alleged breach and protect its interest under the contract once it receives notice of the owner's alleged basis for termination.

---

<sup>16</sup> Id., §14.2.2.

<sup>17</sup> Id. at 7, §2.4.1.

## **B. Notice to the Surety**

Where the contractor has provided a performance bond for the project, the owner must not forget to provide timely notice to the surety before terminating the contract because of the contractor's default. As a general matter, there is no obligation to notify the surety before declaring a default and terminating the contract.<sup>18</sup> However, a provision in the bond itself which requires notice to the surety will ordinarily be enforced in any subsequent legal proceeding. Moreover, the construction contract itself may require notice to the surety.<sup>19</sup>

Once the owner has complied with the notice provisions in the bond and has declared a default by the contractor, the surety will generally have the option to complete the project itself (directly or through agents) or pay the cost of completion (up to the amount of the bond) to the owner. AIA Document A312 gives the surety the following options:

1. to arrange for the contractor to complete the job, but only if the owner consents;
2. to perform the contract itself, through agents or independent contractors;
3. to obtain a bid for completion of the work by the contractor acceptable to the owner, secured by bonds equivalent to those issued on the original contract, and pay the owner the cost of so completing the work, up to the amount of the bond;
4. to promptly determine the amount of its liability to the owner, and pay the owner that amount; or

---

<sup>18</sup> See, e.g., *School District v. Universal Surety Co.*, 135 N.W.2d 232, 237 (Neb. 1965).

<sup>19</sup> See, e.g., AIA Document A201-1997, §14.2.2.

5. to deny liability and notify the owner in writing of the reasons for doing so.

### **C. Documenting the Default**

The notice of default to the contractor and surety is an important piece of information. There is a substantial risk that litigation will ensue and the notice of default will become a critical piece of evidence. Therefore, the notice should be as complete and as objective as possible. In addition, there should be substantial documentation to prove the elements of the default as set forth in the notice to the contractor and its surety.

In the case of defective or nonconforming work, the owner should obtain written reports from the architect and any other parties responsible for monitoring the progress and quality of work as well as any available photographs and videotapes. In the case of the contractor's failure to adhere to the construction schedule, copies of the as-planned construction schedule (including updates) and any available progress reports, such as those contained in the contractor's applications for payment, should be retained in the owner's file for future reference. When the contractor has violated applicable laws, ordinances or regulations, the owner should be sure to obtain copies of any reports or citations issued by the relevant enforcement or regulatory bodies.

Regardless of the default alleged, the owner should bear in mind the potential need to demonstrate the default through documentary evidence in any substantive dispute with the contractor. If possible, a list of persons with knowledge of the surrounding facts and circumstances should also be prepared at the time the decision to terminate is made. As time passes and memories fade, such a list may become a valuable resource.

### **III. THE OWNER'S REMEDIES UPON TERMINATION FOR DEFAULT**

A construction contract should not only describe the circumstances under which the owner may terminate, but should also contain a list of remedies available to the owner in the event of default by the contractor. In the absence of such a list, the court may look to the parties' intent as reflected by extrinsic evidence. It is best to define the owner's remedies in the contract in such a way as to provide the owner the flexibility to complete the project and to protect the owner's interest. Among the remedies which should be included are the following:

#### **A. Taking possession of the site, unused materials, equipment, machinery and tools**

The owner should be able to take possession of the project in its entirety in order to effect completion by the surety or by a substitute or completing contractor. AIA Document A201 provides that in the event of default by the contractor, the owner may terminate the contract and:

take possession of the site and of materials, equipment, tools and construction equipment machinery thereon owned by the Contractor.<sup>20</sup>

#### **B. Taking an assignment of subcontracts or finding new subcontractors**

In almost all circumstances, the work under the construction contract will actually be performed by subcontractors. When the owner terminates the contractor, it may wish to retain some, all, or none of the existing subcontractors to complete the project. Accordingly, the contract should include the flexibility for the owner to take an

---

<sup>20</sup> AIA Document A201-1997, § 14.2.2.1

assignment of the desired subcontracts in the event the general or prime contract is terminated. To create that flexibility, AIA Document A201 provides that:

Each subcontract agreement for a portion of the work is assigned by the Contractor to the Owner provide that ... (1) assignment is effective only after termination of the Contract by the Owner for cause ... and only for those subcontract agreements which the Owner accepts by notifying the Subcontractor and Contractor in writing; and (2)... assignment is subject to the prior rights of the surety, if any ...”<sup>21</sup>

---

<sup>21</sup> Id., §5.4.1

### **C. Completing the project**

Once the owner has terminated the contract and excluded the contractor from the site, it probably goes without saying that the owner may undertake to complete the project by whatever means it deems reasonable and appropriate. To ensure that there is no argument in regards to whether the owner must await some adjudication of its claims against the contractor before proceeding with the project, it should be stated in the contract that immediately upon termination, the owner may proceed to complete the project as it sees fit.<sup>22</sup>

## **IV. PRACTICAL CONSIDERATIONS**

Terminating a construction contract for cause will have serious impacts which go well beyond the owner's legal rights and obligations under the construction contract. In a default termination situation, the contract time and price will almost always dramatically increase. Set forth below are some practical considerations which must be weighed before the owner decides to terminate:

### **A. Exhaust all other options**

Many contracts provide the owner with options short of termination for the very reason that termination is such an extreme and risky proposition. The owner should explore those options for the sake of the project, as well as to strengthen its position in any post-termination litigation. The various options should be pursued and systematically exhausted in a sincere and professional manner. Simply going through the motions as part of a rush to termination will not help and could hurt the owner's case. Some of the more common contractual and other options for non-performance include (1)

---

<sup>22</sup> Id., §14.2.2.3

withholding payment, (2) refusal to pay for defective work, (3) liquidated damages, (4) acquire change of personnel, (5) correct defective work and backcharge contractor, (6) stop work order, (7) require involvement of a surety, (8) deductive change order, (9) declare default but allow contractor to continue to perform with conditions, (10) declare default and supplement contractor's forces and (11) renegotiate contract.

**B. Delays in completion of project**

Perhaps the most obvious practical effect of termination is the resulting delay in completion of the project. For many reasons, the owner may simply not have the flexibility to extend the project schedule to absorb that delay, which may be lengthy and may consist of several components, such as (1) notice and cure period, (2) delays associated with surety's involvement, (3) retaining a completing contractor, (4) procurement procedures with respect to a public contract, and (5) a general loss of momentum. Each of the elements will delay the project and the owner should evaluate such delays prior to issuing the notice of termination.

**C. Increase in project price**

By terminating the contract for cause and completing the project with a completing contractor, the owner will almost always increase the price of the project. The increased price may ultimately be recovered in damages from the defaulting contractor and/or its surety, but that recovery will likely occur, if at all, long after the owner has completed the project and has paid the cost of completion. The increased project price can result from several factors such as the following:

1. The completing contractor will be more expensive, proportionately, for the remainder of the project,

2. The potential for deterioration of the completed work and the risk of loss or damage to stored materials,

3. There will be additional architecture and engineering fees,

4. There should be attorneys fees, and

5. There will be an increased cost of financing.

**D. Litigation risks**

Finally, there is a risk associated with any threatened litigation. Not only might the owner lose its claim for damages against the contractor, but it may be exposed to a judgment for damages if a judge, jury or arbitration panel finds that the owner wrongfully terminated the contract. In addition, even if the owner is successful in having the contractor determined to be the party in default of the contract, the owner may not recover all of its costs and damages in completing the work of the contractor.

**V. GROUNDS FOR TERMINATION BY A CONTRACTOR**

As indicated initially in this paper, default determination by a contractor is relatively rare, because in most construction contracts the grounds for contractor termination are few. AIA Document A201-1997, §14.1.1, recognizes only three grounds:

(a) Stoppage of the work by governmental in court action, through no fault of the contractor or any of its forces for more than 30 days;

(b) Stoppage of the work for 30 days because the architect has not issued a certificate of payment; or

(c) Because the owner has not furnished reasonable evidence of financial arrangements to fulfill its obligations under the contract.

The AIA Document A201-1997, §14.1.3 still requires that the contractor give an additional seven (7) days written notice to the owner and architect, after which the contractor has the right to terminate the contract. But most courts have recognized non-payments as grounds for stoppage, and ultimately termination.<sup>23</sup>

As noted above, non-payment by the owner does not necessarily mean failure to pay what the contractor believes is due. Non-payment by the owner means failure by the owner to pay what the architect certifies is due, considering deduction from payments for defective work, lien claims and other contractual grounds for reducing progress payments.<sup>24</sup>

Obviously, on construction projects there will be disputes between the contractor and the architect over the contractor's claims for payment, or the architect's reduction of payments. A good set of contract documents will require a method of resolving those disputes without permitting the contractor to terminate. For example, the AIA General Conditions provide that such claims should be resolved by mediation and arbitration, after the architect has made his decision.<sup>25</sup> However, the General Conditions do not allow the contractor to stop work during the pendency of the arbitration.<sup>26</sup>

The worse case scenario for a contractor is one where a dispute arises in which the architect reduces or stops payment to the contractor, ostensibly under the specific terms of the contract, and for whatever reason the contractor has inadequate resources to continue the work without the payment which has been blocked or withheld. Thus,

---

<sup>23</sup> *United States, ex rel E.C. Ernest, Inc. v. Curtis T. Bedwell & Sons, Inc.*, 506 F. Supp. 1324 (ED PA. 1981)

<sup>24</sup> AIA Document A201, § 9.6.1

<sup>25</sup> *Id.*, §4.5 and 4.6

<sup>26</sup> *Id.*, §4.3.3

although the contractor has a duty to go forward, he is without the resources to do so. There are rare and limited circumstances in which the courts have excused a contractor's failure to go forward.<sup>27</sup>

From the contractor's perspective, the contractor should review all available defenses in the event of an owner termination. The key contractor defenses which should be reviewed as potentially applicable are (1) excusable delays, (2) cardinal change, (3) impossibility of performance, (4) bad faith by the owner and (5) tortious interference by other or third parties. Finally, with so much at stake in a default termination, all parties should be aware of and be prepared for a bankruptcy filing.

## **VI. CONCLUSION**

Default termination is obviously a very risky endeavor. There are no certain answers on what an owner or contractor should do in a default situation. Each case will likely present most of the problems discussed herein as well as a few new ones. The mixture of problems will be unique to each case.

The best solution for each case can only be determined with a full understanding of the operative legal principals and, more importantly, a knowledge of the critical facts in the case. In light of the principals and facts, the attorney weighs all the factors discussed herein, remembering that it is, after all, an economic process; and economic considerations control the decisions. After making your careful and thoughtful decision regarding termination for default, you must then hope for an understanding judge, jury or arbitration panel.

Special thanks to Charles F. Seemann, Jr. of Deutsch, Kerrigan & Stiles, New Orleans, Louisiana and Thomas J. Ragonetti of Otten, Johnson, Robinson, Neff & Ragonetti, P.C.,

---

<sup>27</sup> *Northern Corp. v. Chugach Electric Association*, 518 P.2d 76 (Alaska 1974)

Denver, Colorado for use of their previously prepared papers on default termination for the American Bar Association, Forum on the Construction Industry.