

CHAPTER 3.3
THE LAW OF CONTRACT TERMINATIONS:
ALTERNATIVES AND CONSEQUENCES

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CHAPTER 3.3

THE LAW OF CONTRACT TERMINATIONS: ALTERNATIVES AND CONSEQUENCES

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§ 3.3.1 Introduction

Perhaps the best advice given for this area of construction law should be “Hope for the best, plan for the worst.” Since contract terminations yield more than their fair share of litigation, financial loss, and lasting recrimination, the prudent contractor must plan for the possibility of failure with the same care that it plans for a successful project. The seeming inevitability of construction—from the initial site excavation through “topping out” to completion of the punch list—obscures the fact that not every project is completed, or completed by the same team that started it. Some projects are never completed.

§ 3.3.2 Chapter Scope

This chapter¹ examines the conditions that prompt an owner or contractor to terminate a contract for construction. It explains the legal principles underlying voluntary and involuntary terminations, the procedures and notices required for a proper termination, and the consequences of termination for all parties affected by this decision. It also evaluates some common termination scenarios and the legal or equitable remedies available to each party in the contracting chain.²

Specific topics discussed in this chapter include:

1. Grounds for termination
2. Notice requirements
3. Statutory or contractual termination procedures
4. Defenses to involuntary termination
5. Termination for convenience

¹ Mr. Folk gratefully acknowledges the assistance and contributions of Attorneys James B. Wright and Jenna M. Grady of Clark Hill PLC in the latest edition of this chapter.

² Terminations of supply contracts or purchase orders for goods covered by the Uniform Commercial Code (UCC) are beyond the scope of this chapter.

5. Termination for convenience
6. Rights and remedies after termination³

§ 3.3.3 Classification of Termination Scenarios

While the circumstances prompting a contract termination may vary from one project to the next, they can be grouped for analytical purposes into four main classes of cases: (1) terminations for cause;⁴ (2) terminations for convenience; (3) mutual terminations; and (4) rescissions. Termination for cause carries the risk of monetary damages for breach of contract or other penalties (such as debarment) for the defaulting party. At the other end of the spectrum, a mutual termination often amounts to a “soft landing” with a minimum of adverse consequences. Nonetheless, owners and contractors should weigh carefully the consequences of a contract termination before making such a significant decision. The risks of a wrongful termination can extend beyond the realm of contract damages because the injured party might also assert tort claims against the terminating party such as fraud, defamation, or tortious interference with contracts.

Historically, only government agencies could terminate contracts unilaterally “for convenience,” but the concept was later adopted by the private sector and generally accepted, as evidenced by the 1997 edition of the American Institute of Architects Standard Forms of Agreement.⁵ The following sections of this chapter discuss the legal causes and consequences of termination for both public and private construction projects.⁶

³ This chapter includes unpublished opinions of Arizona appellate courts as an aid to research and analysis, drafting contracts, or litigation practice. Citation to unpublished decisions is subject to the restrictions of 17A Ariz. Sup. Ct. Rules, Rule 111(c)(1)(C): “Memorandum decisions of Arizona State courts are not precedential and such a decision may be cited only: ... for persuasive value, but only if it was issued on or after January 1, 2015; no opinion adequately addresses the issue before the court; and the citation is not to a depublished opinion or a depublished portion of an opinion.”

⁴ The phrases “termination for cause” and “default termination” are used interchangeably in this chapter. They both refer to situations in which a contracting party has been terminated because it repudiated or failed to perform a material obligation without having an adequate excuse for doing so.

⁵ AIA contract documents mentioned in this chapter may be purchased from the American Institute of Architects, 1735 New York Ave., NW, Washington, DC 20006 / 202-626-7300, or online at www.aia.org. AIA contract documents may also be purchased by contacting AIA Arizona, 30 N. Third Avenue, Suite 200, Phoenix, AZ 85003 / 602-252-4200 or online at “www.aia-arizona.org”.

⁶ Arizona courts look for guidance to the RESTATEMENT (SECOND) OF CONTRACTS, and decisions of federal boards of contract appeals or courts in deciding public contract law issues that have not been addressed previously in a published Arizona decision. *New Pueblo Constructors, Inc. v. State*, 144 Ariz. 95, 696 P.2d 185 (1985). Cases from other state and federal courts have also been cited when they illustrate a legal principle or a trend that Arizona courts are likely to follow. Nonetheless, care should be taken in relying on precedent that has not been formally adopted by the courts of Arizona.

The legal principles and procedures developed under federal procurement law are discussed first because they have often shaped private sector practice in many ways. Also, federal cases often provide guidance for contractors and owners in the private sector when state courts have not yet addressed a particular legal issue.

§ 3.3.4 Termination for Cause

§ 3.3.4.1 When Authorized by Contract Terms or Government Regulations

§ 3.3.4.1.1 Contracts With the Federal Government

The terms for most construction contracts awarded by the federal government are contained in a detailed set of rules known as the Federal Acquisition Regulation (FAR).⁷ The FAR specifies both the terms of the contract and the rules by which the contract will be enforced. The government can terminate every federal construction contract for the contractor's failure or refusal to perform the work, or any portion of it, with sufficient diligence to assure completion within the time allowed.⁸ Termination for cause is also permitted for breach of any other material term of the contract; refusal to follow a direction given by the contracting officer; or fraud in connection with the contract.⁹ A contractor's anticipatory repudiation of its obligation to perform can also serve as justification for a default termination.¹⁰

The FAR contract terms allow a contractor facing a default termination by the government only one excuse: It must prove that its delay or defective performance was due to unforeseeable causes beyond its control, and without its fault or negligence.¹¹ The contractor must give timely notice to the government of these circumstances excusing its faithful performance of the contract *before* the notice of default termination is issued. Once a federal contract is terminated, the government is not likely to retract its decision. Events considered "excusable delays" under the FAR termination clause include acts of God, acts of the government in either its sovereign or contractual capacity, and acts of another contractor in performance of *its* contract. Fires, floods, epidemics, quarantine restrictions, strikes, freight embargoes, or unusually severe weather, or any event or occurrence that would be considered an "excusable delay" for one of the prime contractor's subcontractors or suppliers, are also included under this heading.

⁷ References to the FAR in this chapter are taken from the most recent publication found at Title 48, C.F.R., vol. 1–4, rev. July 25, 2014. A searchable online edition of the FAR can be found at "https://www.acquisition.gov/Far/".

⁸ FAR Standard Contract Clause 52.249-10

⁹ *Great Northern Forestry Serv.*, 90-2 B.C.A. (CCH) ¶ 22,668 (AGBCA 1990); *Roger Dean Barrett*, 90-1 B.C.A. (CCH) ¶ 22,526 (PSBCA 1989) (refusal to obey contracting officer); *Ke'R Eng'g Co. v. United States*, 616 F.2d 469 (Ct. Cl. 1980) (fraud).

¹⁰ *Precision Cable Mfg. Co.*, 90-2 B.C.A. (CCH) ¶ 22,833 (ASBCA 1990).

¹¹ FAR Standard Contract Clause 52.249-10.

The burden is on the prime contractor to prove that neither it nor its subcontractor could have foreseen or avoided the delay event. Problems getting a supplier to perform its work, the breakdown of equipment needed for the project, and financial problems not caused by the government are usually not excusable causes for delays in performance.¹²

To use excusable delay as a defense to a default termination, the contractor must notify the contracting officer or designated contracting officer's representative, *in writing*, of the cause for delay within 10 days after it begins. If the contracting officer finds the delay excusable, he or she may extend the time for completion of the work. A sample notice of excusable delay and request for time extension and/or additional compensation is included as Appendix 1 to this chapter.

The contracting officer's decision to allow a time extension or terminate the contract is final and conclusive, but it is also subject to further appeal under the contract disputes clause.¹³ Even if the contracting officer refuses to allow a time extension for the delay, he or she may be persuaded to convert a default termination to a termination for convenience when provided with good cause to do so. If so, that could help the contractor avoid the stigma of a default termination (which would have to be disclosed on future pre-qualification questionnaires) and the payment of damages or penalties to the government for failing to complete the project.

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- Contractors expecting difficulty in completing a project should promptly document all potential causes of excusable delay. These potential claims for time extension or equitable adjustment of the price can be used as bargaining chips in future negotiations with the contracting officer to avoid a default termination or the imposition of liquidated damages or other back-charges due to delay.
- Prime contractors should also include appropriate terms in their subcontracts binding their subcontractors by the government's decision to terminate the prime contract, so the subcontractors will share the burden of any termination costs, liquidated damages, or other penalties that may properly be charged against them.¹⁴

¹² *Cumberland Mach. Co.*, 87-1 B.C.A. (CCH) ¶ 19,416 (ASBCA 1986) (supplier problem); *W. Mach. Co.*, 87-3 B.C.A. ¶ 20,085 (AGBCA 1987) (equipment failure); *In re Boston Shipyard Corp. Military Sealift Command*, 886 F.2d 451, 35 C.C.F. (CCH) ¶ 75,728 (1st Cir. 1989) (financial problems).

¹³ The Contracts Disputes Act of 1978, as amended, 41 U.S.C. §§ 601–613, (“CDA”) establishes a procedure for resolving all significant disputes between the government and its contractors. These procedures have been incorporated into the FAR at Subpart 33.2 (2005).

¹⁴ See FAR § 49.108-2 and Subpt. 49.5 (2005)

If the contracting officer's decision to terminate a contract for cause is later found to be wrongful, that termination will be treated as a termination for convenience.¹⁵ When appealing a termination under the federal Contracts Disputes Act ("CDA"), the government can also defend its default termination on grounds different than those originally given to the contractor, provided the alternative grounds also existed at the time of the termination. It makes no difference that the contracting officer may not have known about the alternative basis to terminate at the time notice of default was given to the contractor.¹⁶

If the government terminates a contract for the contractor's failure to prosecute its work diligently, the government has the burden to prove both that the delay was significant and that the contractor could not have completed its performance within the time allowed.¹⁷ Even if the contractor has delayed completion of the project, a default termination decision may be overturned if sufficient time remains for the contractor to complete its performance.¹⁸

The contracting officer can terminate immediately, without notice or an opportunity to cure, if the contract time has expired and performance is not complete.¹⁹ When time is not of the essence, late performance is only one of a number of factors that a court will consider in assessing the adequacy of the contractor's performance and the justification for a default termination.²⁰ In that case, the contracting officer will issue a notice to cure,²¹ or show cause notice,²² to the contractor, depending on the severity of the default and the likelihood that the contractor can cure its default before termination is necessary or justified. A notice to cure usually issues when the contractor's deficiency is correctable within the time remaining under the contract. A sample notice to cure is included as Appendix 2 to this chapter.

A show cause notice will usually be issued after the allotted time for performing the contract has expired, or when the contractor has failed to cure prior events of default under the contract. The show cause notice is intended to give the contractor a final opportunity to demonstrate good cause why its contract should not be terminated. If the delinquent contractor does not respond promptly or appropriately to the show cause

¹⁵ See FAR § 49.401(b) (2005).

¹⁶ *Joseph Morton Co. v. United States*, 757 F.2d 1273, 32 C.C.F. (CCH) ¶ 73,277 (Fed. Cir. 1985).

¹⁷ See *Litcom Div., Litton Sys.*, 78-1 B.C.A. (CCH) ¶ 13,022 (ASBCA 1978).

¹⁸ See, e.g., *Strickland Co.*, 67-1 B.C.A. (CCH) ¶ 6,193 (ASBCA 1967).

¹⁹ See, e.g., *National Farm Equip. Co.*, 78-1 B.C.A. (CCH) ¶ 13,195 (GSBCA 1978); *Dallas-Ft. Worth Regional Airport Bd. v. Combustion Equip. Assocs., Inc.*, 623 F.2d 1032 (5th Cir. 1980).

²⁰ *Franklin E. Penny Co. v. United States*, 524 F.2d 668 (Ct. Cl. 1975).

²¹ FAR § 49.607 (2005).

²² *Id.*

formally terminate the contract. The FAR contains a detailed procedure for communicating notice of the termination; winding down the project, completing a settlement with the terminated contractor; and paying all claims related to the contract.²³ A sample default termination notice is included as Appendix 4 to this chapter.

As noted above, the government may elect—either before or after sending the notice of termination—to treat it as a termination for convenience rather than a default termination.²⁴ In the event of a default termination, the government can seek to have the contractor's performance bond surety complete the project, or pay damages caused by the need to retain another contractor to complete the work. Since the consequences of a convenience termination may be less burdensome to the contractor and its subcontractors, a government contractor facing termination may find it advantageous to invite a convenience termination by the contracting officer.

Subcontractors of the contractor whose contract has been terminated have no contractual recourse against the government after termination.²⁵ They must pursue their legal remedies against the terminated prime contractor or intermediate subcontractor with whom they had a contract. Provided the subcontractor was not also in default, it should have the right to recover payment for completed work, and possibly damages associated with the termination, from the terminated contractor's payment bond surety. A subcontractor's failure to hold a contractor's license in the state in which the federal project was built does not provide a defense to its claim against the terminated prime contractor's Miller Act payment bond but does not protect the subcontractor from criminal prosecution for contracting without a license.²⁶

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The prime contractor, and any bonded subcontractor, must take particular care to assure that its bonding company is not surprised by a default termination notice. If the surety is forced to complete the contract or pay the government compensation, it may seek to recover those damages from the contractor or its principals (on their indemnity or by equitable subrogation on those claims it has discharged). If the surety has doubts about the principal's ability to manage its bonded work or satisfy the government's damage claim, it will almost certainly freeze the contractor's bonding line for other projects in progress to limit its potential losses. A takeover of the contractor's operations by the surety, or extensive intervention by the surety and its own legal counsel, can result in significant expenses for

²³ FAR Pt. 49, Termination of Contracts (2005).

²⁴ FAR § 49.402-3(j), (k) (2005).

²⁵ FAR § 49.108-1 (2005).

²⁶ *Technica LLC ex rel. United States v. Carolina Cas. Ins. Co.*, 749 F.3d 1149, 1150-51 (9th Cir. 2014).

the contractor and those who have indemnified the surety for its bonds.

§ 3.3.4.1.2 Justifying the Decision to Terminate for Cause

In determining whether a contractor should be terminated for cause, the government must have a clear indication from the contractor that it cannot or will not perform. The case law requires a “positive, definite, unconditional and unequivocal manifestation of intent, by words or conduct on the part of the contractor” not to perform.²⁷ Failure to make progress does not, by itself, constitute anticipatory repudiation without some objective manifestation of the contractor’s intent not to perform the required work. On the other hand, a contractor’s refusal to perform while awaiting interpretation of certain contract provisions may be considered a repudiation of the contract and, therefore, grounds to terminate for default.²⁸ Generally speaking, a contractor may not stop work while awaiting issuance of contract modifications or resolution of a request for price escalation for inflation.²⁹

Conversely, repudiation does not occur when the contract specifications make performance impossible or impractical. The contractor has a right to stop work if no practical alternative exists.³⁰ Furthermore, a contractor should not be terminated for default where it is reasonably waiting for a clarification from the owner or its agents of drawings, specifications, or other central requirements. If the contractor is unable to proceed without obtaining guidance from the owner, the delay in work is justified.³¹ Similarly, a substantial change in the scope of the contract by the government—one that

²⁷ *Mountain States Constr. Co.*, 76-2 B.C.A. (CCH) ¶ 12,197 (ENGBCA 1976).

²⁸ *Tester Corp.*, 78-2 B.C.A. (CCH) ¶ 13,373 (ASBCA 1978).

²⁹ *Fraenkische Parkettverlegung, R.*, 75-2 B.C.A. (CCH) ¶ 11,388 (ASBCA 1975). While there are exceptions to every rule, care should be taken before stopping work on the project. Most standardized contracts, including those with the federal government, obligate the contractor to continue its work while awaiting resolution of a dispute. The legal doctrine of avoidable consequences, also known as the duty to mitigate damages, obligates all parties to a contract to take whatever action may reasonably be necessary to avoid causing additional harm or loss after one party has breached the contract. See RESTATEMENT (SECOND) OF CONTRACTS § 350 (1979).

³⁰ See, e.g., *L.J. Casey Co.*, 76-2 B.C.A. (CCH) ¶ 12,196 (AGBCA 1976).

³¹ *Electro Magnetic Indus., Inc.*, 67-2 B.C.A. (CCH) ¶ 6545 (ASBCA 1967).

would constitute a “cardinal” change³²—does not obligate the contractor to perform, and it cannot be used as justification for a default termination.³³

§ 3.3.4.1.3 Termination for Cause on ADOT Projects

Arizona’s Department of Transportation (ADOT) has adopted its own Standard Specifications for Road and Bridge Construction (2008)³⁴ (referred to in this chapter as the “ADOT Specs”), which govern construction undertaken for that agency. Section 108.10 of the ADOT Specs sets forth several specific grounds on which a contractor may be terminated for default. These include the following acts or events of default:

1. Failure to commence work within specified time.
2. Failure to provide sufficient labor, materials, or equipment to assure prompt completion.
3. Unsatisfactory work, and failure to correct rejected, unsatisfactory, or unsuitable work.
4. Discontinuance of work without excuse or permission.
5. Failure to resume work within a reasonable time after receiving notice to proceed.
6. Insolvency or bankruptcy of the contractor.
7. Failure to satisfy a final judgment within 10 days.
8. Making an assignment for benefit of creditors.
9. Failure to comply with minimum wage or equal opportunity requirements.
10. Failure to carry on the work in an acceptable manner, regardless of the cause.

ADOT must give the contractor and its performance bond surety 10 calendar days’ advance notice, in writing, of its intent to terminate the contract for default.³⁵ If the contractor or its surety does not cure the defects in its performance within that time, then

³² A “cardinal change” is one or more modifications to the contractor’s scope of work that—either singly or collectively—go far beyond the terms of the original contract, imposing a substantially different obligation on the contractor. *See Wunderlich Contr’g Co. v. United States*, 351 F.2d 956 (Ct. Cl. 1965) (discussion of “cardinal change” rule as applied to federal contracts).

³³ *See Allied Mat’ls & Equip. v. United States*, 569 F.2d 562 (Ct. Cl. 1978).

³⁴ The 2008 ADOT Specs was the current edition at the time of publication. These specifications are updated as needed by the Department. Copies of the ADOT Specs can be purchased from the Engineering Records Department of the Arizona Department of Transportation, 1655 W. Jackson, Room 175 Mail Drop 112F, Phoenix, AZ 85007-3217. (602) 712-8216. Publication information is also available on the ADOT Website: “<http://www.azdot.gov/business/ContractsandSpecifications/Specifications>”.

³⁵ ADOT Specs § 108.10.

the Department may authorize a written notice by its resident engineer³⁶ of the default termination. If the contractor's performance bond surety does not assume responsibility for completing the work, ADOT may appropriate and use the contractor's equipment and materials, and take any other action it deems necessary to complete the project.³⁷ ADOT will deduct its costs to complete the project from the balance of the contract price, and charge any excess completion costs (after crediting all sums earned by the contractor or remaining under the contract) against the terminated contractor or its surety.³⁸

There is an open question as to whether ADOT can collect both the liquidated damages for delay permitted by ADOT Specs. § 108.09, and actual damages incurred in completing the project. There is no reported decision in Arizona precisely on point.³⁹ Many other states have held that a public owner may recover *both* liquidated damages for delay and excess costs of completion from the terminated contractor.⁴⁰

In another twist on the rules of cost recovery, the Arizona Court of Appeals has held that ADOT may offset other legal obligations of the terminated contractor—such as unpaid unemployment taxes owed to the Department of Economic Security—from the balance of the contract funds owed to the contractor and its surety.⁴¹ Presumably the same rationale could be used to offset other debts of the contractor to state government against contract proceeds (*e.g.*, sales, use, and income taxes).

§ 3.3.4.1.4 Termination for Cause on County and Municipal Projects

Most construction projects for Maricopa County, municipalities, and special improvement districts within the county, are governed by the Uniform Standards and Specifications of the Maricopa Association of Governments (referred to in this chapter as

³⁶ ADOT delegates authority to its personnel administering construction contracts in a manner similar to federal contracting practices. The “resident engineer” is ADOT’s equivalent to the “contracting officer” under federal contract law.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Cf. Mech. Air Eng’g Co. v. Totem Constr. Co.*, 166 Ariz. 191, 801 P.2d 426 (Ct. App. 1989) (no need to prove actual damages to recover liquidated damages per contract).

⁴⁰ *See Lamson v. Durant*, 518 P.2d 549, 551 (Kan. 1974) (provision in contract liquidating certain items of damage will not prevent the recovery of actual damages for other items to which liquidation provision does not apply, unless contract expressly provides that damages other than those enumerated shall not be recovered); *see also Oregon State Highway Comm’n v. DeLong Corp.*, 495 P.2d 1215 (Or. Ct. App. 1972); *cert. denied*, 411 U.S. 965, *reh’g denied*, 412 U.S. 944 (1973) (state recovered \$1.7 million in excess costs and \$952,000 in liquidated damages for delay). The Supreme Court of Alaska has denied a recovery of both actual and liquidated damages by a state agency, but the reasoning of that decision is open to criticism. *See Arctic Contractors, Inc. v. State*, 564 P.2d 30 (Alaska 1972).

⁴¹ *Hartford Acc. & Indem. Co. v. Arizona Dep’t of Transp.*, 172 Ariz. 564, 838 P.2d 1325 (Ct. App. 1992).

the “MAG Specs”).⁴² These standard specifications are modeled after the ADOT Specs and authorize default terminations for the same general reasons, and with comparable consequences.⁴³ The only significant difference under the MAG Specs default termination provision is that the contractor and its surety are given 14 calendar days’ advance written notice of the owner’s intent to terminate for default.⁴⁴

The MAG Specs authorize the agency to take over the contractor’s materials and equipment, use other contractors to complete the project, and charge the defaulted contractor liquidated damages for delay and any excess costs of completion.⁴⁵ Contractors should note that, while certain provisions of the MAG Specs, including the liquidated damages provision in § 108.9 and the termination for convenience clause in § 108.11, did not apply to improvement districts in the past, the current MAG Specs have eliminated this exclusion. For improvement district projects the words “Superintendent of Streets” will be substituted for the word “Engineer.” Any extension of contract time will be determined by Superintendent of Streets with the consent of the district’s governing body.

When a construction contract incorporates both the MAG Specs liquidated damages for delay provision, and an unambiguous remedy allowing the contracting agency to recover its actual damages incurred in completing a project following the original contractor’s default and termination, the agency may recover both types of damages.⁴⁶

The board of directors for a special improvement district is empowered by A.R.S. §48-924.D to conduct a hearing to determine if the contractor is failing to perform its contractual and statutory obligations, and further to render a final and conclusive determination of the contractor’s default. The Board’s determination can have *res judicata* effect to bar any claim by the contractor against the district if the contractor fails to participate and present its counterclaims in that hearing.⁴⁷

Pima County and the City of Tucson, by intergovernmental agreement, have adopted their own Standard Specifications for Public Improvements (referred to as “Pima County

⁴² The 2012 edition of the MAG Specs, with revisions through 2014, was in use at the time of publication. These specifications are updated as needed by the Standard Specifications & Detail Committee of the Maricopa Association of Governments. Copies of the MAG Specs may be purchased from the Maricopa Association of Governments, 302 N. First Avenue, Suite 300, Phoenix, AZ 85003. (602) 254-6300. The current edition of the MAG Specifications is also available at “http://www.azmag.gov/communications/Specs_and_Details/default.asp”.

⁴³ MAG Specs § 108.10.

⁴⁴ Contractors on county or municipal projects should also review the general and special conditions of their contract documents to determine whether they contain any other provisions applicable to default terminations that override the MAG or Pima County Specs.

⁴⁵ *A. Miner Contr., Inc. v. Tobo-Tolani County Improvement Dist.*, 233 Ariz. 249, 258, ¶ 26 311 P.3d 1062, 1071 (Ct. App. 2013); *rev. den.* (Mar. 21, 2014).

⁴⁶ *Id.* at 258, ¶¶23-26 311 P.3d at 1071.

⁴⁷ *Id.* at 254-256, ¶¶13-22 311 P.3d at 1067-1069.

Specs”)⁴⁸ for all construction projects awarded by either governmental unit. These specifications also mirror the ADOT Specs with regard to termination for default, although only 10 calendar days’ notice of default is required before the awarding agency may terminate the contract.⁴⁹ If it is subsequently determined that a contractor terminated under this provision was not in default, the termination will be treated as a termination for convenience under §108.11 and the contractor’s damages will be limited as provided in that section. The Pima County Specs are more comprehensive than the MAG Specs in many respects, so contractors should not assume the two documents are identical in every term or condition.

The contract documents and specifications used by other counties and communities in Arizona vary so widely that no general rule can be stated for projects outside Maricopa and Pima County. Contractors must consult the general and special conditions of their contracts to determine whether the MAG or Pima County Specs have been adopted by reference, or whether some other legal terms allowing termination for default have been adopted.

§ 3.3.4.1.5 Termination for Cause Under Arizona State Procurement Code

Except for certain agencies or branches of government exempted by statute, most state building construction projects are governed by the Arizona Procurement Code.⁵⁰ Generally speaking, those agencies exempted from the Procurement Code are required to adopt procurement procedures that are substantially equivalent to the Code. Municipal governments and other local public agencies are also encouraged to adopt the Arizona Procurement Code for their construction and other procurement needs.⁵¹ While the procurement code authorizes the Director of the Department of Administration (DOA) to adopt rules and regulations for the procurement of construction services,⁵² those regulations do not address the subject of contract terminations. In recent years, the DOA has used a modified form of the American Institute of Architects (AIA) Contract Form A201, General Conditions of the Contract for Construction, to specify all terms and conditions applicable to the prime contractor.⁵³ These contract terms, when read in conjunction

⁴⁸ The 2003 edition of the Pima County Specs was in use at the time of publication. This document does not exempt improvement districts from the application of certain sections as the MAG Specs do. Nonetheless, contractors working on improvement districts in Pima County should determine whether all provisions of the Pima County Specs apply. These standard specifications can be purchased from the Engineering Information Management Section, Technical Services Division of the Pima County Department of Transportation, 201 N. Stone Ave., 5th Floor, Tucson, AZ 85701-1207, and they also can be downloaded from the Pima County Department of Transportation’s website at “<http://www.dot.pima.gov/transeng/stdspecsdet>”.

⁴⁹ Pima County Specs § 108-10.

⁵⁰ A.R.S. § 41-2501 *et seq.*

⁵¹ *See* A.R.S. § 41-2501(C).

⁵² A.R.S. §§ 41-2511(A) and 41-2514.

⁵³ This modified form, the A201-2007 with 2008 Arizona modifications, can be obtained from “<http://gsd.azdoa.gov/ConstructionReview.html>”.

with the Procurement Code, provide the legal framework for handling a default termination on a state construction project.

Article 14.2 of the DOA contract authorizes termination for cause “upon the repeated occurrence of and failure to correct any one or more of the following” acts or omissions:

1. Refusal or failure to prosecute the work, or any separable part of it, with such diligence to ensure its timely completion.
2. Failure to supply sufficient labor, materials, or equipment.
3. Failure to make prompt payment to subcontractors and suppliers.
4. Failure to comply with legal requirements of any public entity having jurisdiction, or as provided in the contract.
5. Failure to follow any reasonable instruction by the architect or owner.
6. Deviation from the contract documents.
7. Violation of any other material provision or requirement of the contract.

This termination clause differs from the standard A201 provision in two notable respects: (1) as noted above, the specified events of default must be “repeated” and “uncorrected” to justify termination; and (2) certification of default by the architect is *not* required before the owner may terminate a DOA contract. DOA, as the project owner, may exercise its right to terminate for default by issuing a written declaration of default on 7 calendar days’ notice to the contractor and its surety.⁵⁴

If the owner terminates for cause, it may take possession of the work and any materials or equipment of the contractor present on the project, and use them to complete construction.⁵⁵ It may also accept the assignment of any subcontracts or open purchase orders held by the defaulted contractor, and it may cause them to be re-assigned to a replacement prime contractor.⁵⁶ All subcontractors must agree to this conditional assignment in their subcontracts to the DOA, and agree also to complete their work at the request of DOA or its completion contractor if the original prime contractor is terminated for default.⁵⁷

While existing subcontracts are often assumed by the replacement contractor after a default termination, it is not clear what remedy a subcontractor would have to collect payment for its completed work if its agreement were *not* assumed by the owner or

⁵⁴ A201-2007 with 2008 Arizona modifications, art. 14.2.2.

⁵⁵ *Id.* art. 14.2.3.

⁵⁶ *Id.* arts. 14.2.5, 14.2.6.

⁵⁷ *Id.*

completion contractor.⁵⁸ Presumably it still has a contract or *quantum meruit*⁵⁹ claim against the terminated contractor and its surety. In all likelihood, if the subcontractor had any claim against the DOA for the lost profits and unrecovered overhead expenses for the balance of its uncompleted contract, it would have to pursue that claim subject to the state's statutory and common law defenses under the claims statute A.R.S. § 12-821.01

The terminated contractor will be liable for the owner's excess costs of completing the contract, including additional fees paid to architects and consultants, if those costs exceed the balance remaining on its contract. Under the DOA contract, the terminated contractor is also ineligible to compete for any contract awarded for the completion of the project.⁶⁰ These disqualification clauses can be somewhat controversial because they can interfere with the economical completion of the project. In some cases it may be more economical to use the defaulted contractor, who is already working on the project, than it would be to hire a completion contractor who is not familiar with the project. Presumably, DOA could be persuaded to waive this disqualification provision under appropriate circumstances. If not, the defaulted contractor or its surety may claim that DOA has not properly mitigated its damages if it refuses the surety's request to use the terminated contractor to complete the project.

Like the federal government, DOA has also protected itself from the consequences of a default termination that is later deemed unjustified. In that case, the termination will be considered a suspension for the owner's convenience, and the contractor's remedies will be limited to the ones provided by Article 14.3 of the A201-2007 with 2008 Arizona modifications. The prudent contractor should also limit the rights of its subcontractors, under their various agreements, to accept their allocated portion of the termination expenses as a final settlement of their claims.

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Since the DOA contract contains substantial modifications from the original AIA Form A201, prime contractors should notify their subcontractors of all special requirements in the state contract, and bind their subcontractors to those terms with a proper "flow down"

⁵⁸ Cf. *Flooring Sys., Inc. v. Radisson Group*, 160 Ariz. 224, 772 P.2d 578 (1989) (subcontractor on private project may have claim against owner for unjust enrichment if owner does not pay prime contractor for work previously completed); *Jeffrey C. Stone, Inc. v. BMO Harris Bank, N.A.*, No. 1 CA-CV 11-0823, ¶¶ 35-39 (Ct. App. Nov. 23, 2012) (unpaid contractor may have unjust enrichment claim against lender that continued to fund construction loan after borrower's default, inducing reliance and further performance by contractor), and *Wang Elec., Inc. v. Smoke Tree Resort, LLC*, 230 Ariz. 314, 320-321, 283 P.3d 45, 51-52 (Ct. App. 2012) (landlord is not liable to subcontractors of tenant's contractor for unjust enrichment).

⁵⁹ This legal term means a claim for the reasonable value of the labor and materials provided by the subcontractor. *Quantum meruit* claims are sometimes referred to as "unjust enrichment" claims but the two principles are not necessarily identical. The former is recognized as a legal claim, while the latter is an equitable one.

⁶⁰ A201-2007 with 2008 Arizona modifications, art. 14.2.4.

clause. Paragraph 2.1 of the AIA Standard Form of Agreement Between Contractor and Subcontractor, A401-2007, has such a term.

§ 3.3.4.1.6 Default Terminations Under Contracts With Private Owners

Most contracts for construction in the private sector also allow the owner to terminate the contractor for cause. One commonly used form contract is the Standard Form of Agreement Between Owner and Contractor, A101-2007, and its accompanying General Conditions of the Contract for Construction, A201-2007, published by the American Institute of Architects.⁶¹ This contract authorizes termination for four specific events of default:

1. The contractor's persistent or repeated refusal or failure to supply enough properly skilled workers or proper material to complete the work;
2. The contractor's failure to pay subcontractors in accordance with their agreements;
3. The contractor's persistent disregard for laws and regulations of any government entity; or
4. Any other substantial breach of the contract.⁶²

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- The owner may not terminate for a single event of failing to supply sufficient labor or materials, unless that event were so significant that it was a “substantial breach” of the contract. Generally speaking, the contractor must persist in violating a material term of the contract after receiving notice of that violation from the owner, or it must repeatedly violate other material provisions of the contract—again, with notice by the owner and a demand for cure—before the owner would be justified in terminating the contract for cause.
- The owner should always seek a recommendation from its architect, engineer, or construction manager, if one was employed; weigh the significance of the contractor's breach; and consider other means to remedy that breach—such as withholding payment or assessing damages for the breach—before terminating the contract for default.
- Any notice of termination for default must be direct and unequivocal to be effective; requesting the performance of additional work in this notice may make it ineffective as a termination.⁶³

⁶¹ See note 4 for information on how to purchase AIA forms.

⁶² See AIA A201-2007, art. 14.2.

⁶³ *Marana 670 Holdings, LLC v. Spirit Underground, LLC*, Nos. 2 CA-CV 2011-0136, 2 CA-CV

Under the A201-2007, the project architect must certify to the owner that the contractor's default justifies termination of the contract.⁶⁴ Where a contract requires the architect's certification of cause before some other right or obligation accrues, Arizona courts have held this certification to be a condition precedent.⁶⁵

This certification requirement can cause litigation between the contractor and architect in those cases where the contractor disputes the cause of the termination or the architect's good faith in certifying the default. Consequently, the prudent owner and architect should document the grounds for this certification and provide an opportunity for the contractor to cure those defects before terminating for default. A detailed notice of termination on a private contract for construction is provided to give readers some idea of the grounds that might be used to terminate a contract. A sample notice is included as Appendix 5 to this chapter. The unique circumstances of a particular project might require more or less justification than this sample letter provides.

A comparable termination provision for subcontractors is found in Article 7.2 of the AIA Standard Form of Agreement Between Contractor and Subcontractor, A401-2007. One notable difference between the AIA prime contract and subcontract forms is the requirement that the subcontractor receive 10 calendar days' written notice of default and demand for cure, while the Contractor can terminate the prime contract upon only 7 days' written notice of intent to terminate. While the 2007 version of the A401 simplified and shortened the notice of termination provision for subcontractors, some prime contractors still find the provision too lenient, and either modify this provision to shorten the notice and cure period, or they use another form of agreement.

Applying Arizona law, federal courts have held that a contractual notice requirement applies only to defaults that could reasonably be cured within the time allowed; it does not preclude immediate termination for a "vital breach" that could not be cured within the notice period.⁶⁶

§ 3.3.4.1.7 Termination for Cause on School District Projects

While the Arizona Board of Education (BOE) has adopted its own procurement regulations modeled, in part, on the Arizona Procurement Code, the BOE has delegated to individual school districts the discretion to adopt whatever form of contract best serves the needs of that district.⁶⁷ Consequently, considerable variation in policies and contract

2012-0026, ¶¶ 24-26 (Ct. App. Oct. 1. 2012) (unpublished).

⁶⁴ AIA A201-2007, art. 14.2.2.

⁶⁵ *Am. Cont'l Life Ins. Co. v. Ranier Constr. Co.*, 125 Ariz. 53, 607 P.2d 372 (1980) (requirement for architect's certificate approving payment to contractor was a "major substantive right" under contract and a condition precedent to payment).

⁶⁶ *L.K. Comstock & Co. v. United Eng'rs & Constructors, Inc.*, 880 F.2d 219 (9th Cir. 1989) (contract allowed 48 hours notice and opportunity to cure).

⁶⁷ A.A.C. R7-2-1091.

terms can occur from one district to the next. Many districts do, however, base their contracts on standard AIA contracts such as the A201-2007, so that the basic AIA provisions discussed above are often applicable to school projects.⁶⁸ Contractors on school projects should review carefully any supplementary conditions or other modifications to the A201 that alter rights and responsibilities regarding termination. Since many school construction projects are scheduled during limited vacation periods, this owner may move more quickly to terminate a defaulting contractor than others would.

§ 3.3.4.1.8 Termination for Cause on University Projects

The University Procurement Code adopted by the Arizona Board of Regents (“Regents”) is comparable to the BOE regulations in that it delegates to individual universities the discretion to adopt appropriate contract forms.⁶⁹ The Board of Regents has developed its own contract forms for procuring design and construction services. Accordingly, the legal principles applicable to termination of private construction should apply to most university construction projects as well. Contractors should carefully review Regents’ contracts for special terms and conditions affecting terminations.

§ 3.3.4.2 Other Statutory Grounds for Termination of Contracts

In addition to the specific contractual or statutory grounds for termination of a contract discussed above, other laws and administrative regulations (both state and federal) may specifically require or, by implication, permit the early termination of a contract. The terminated contractor may be deprived of the benefits of its contract and, depending on the circumstances and applicable statute or regulation, be forced to pay damages and other penalties. A complete listing of federal or state laws that would justify termination of a contract is beyond the scope of this chapter. A brief list of Arizona laws that might authorize or require termination of a construction contract include the following:

1. Contracting without a proper license.⁷⁰
2. Obtaining construction contracts by means involving an illegal restraint of trade; *i.e.*, anti-trust violations.⁷¹

⁶⁸ In *R.L. Augustine Contr. Co., Inc. v. Peoria Sch. Dist. No. 11*, 188 Ariz. 368, 936 P.2d 554 (1997), the Arizona Supreme Court invalidated the BOE’s administrative claims process then in effect. The Board’s amended procedures for resolving contract claims and controversies are found at A.A.C. R7-2-1155 to 1159.

⁶⁹ UNIV. PROCUREMENT CODE § 3-803(F)(6).

⁷⁰ A.R.S. §§ 32-1151, 32-1153. This statute does not apply to contracts with a Native American tribe for construction on its reservation. *Kenyon v. Karber Constr. Co.*, 144 Ariz. 576, 698 P.2d 1295 (Ct. App. 1985).

⁷¹ A.R.S. § 34-252.

3. Disqualification for conflict of interest caused by hiring a state employee who was responsible for negotiating or awarding the contract on behalf of the government.⁷²
4. Failure to meet equal employment opportunity requirements.⁷³
5. Failure to comply with agency competitive bidding requirements.⁷⁴
6. Violation of state antitrust act.⁷⁵
7. Participation in a scheme or artifice to defraud.⁷⁶
8. Racketeering⁷⁷ and especially the remedies provision.⁷⁸
9. Failure to post payment and performance bonds required by law.⁷⁹
10. Use of an unqualified surety for payment or performance bonds.⁸⁰
11. Failure to properly form a corporation, limited liability company, or limited partnership.⁸¹
12. Violation of open meeting laws.⁸²

§ 3.3.4.3 Common Law Grounds for Terminating Contract

Even in the absence of a statute, administrative regulation, or contract term authorizing termination, Arizona courts recognize the right of one contracting party to declare the other in breach and terminate performance.⁸³ Such powers can be exercised only when a

⁷² A.R.S. § 38-511.

⁷³ A.R.S. § 41-1461 *et seq.*

⁷⁴ See generally procurement rules of agency and *Ganewell Co. v. City of Phoenix*, 216 F.2d 928, modified, 219 F.2d 180 (9th Cir. 1954) (contract extension voided for failure to comply with competitive bidding requirements).

⁷⁵ A.R.S. § 44-1401 *et seq.*

⁷⁶ A.R.S. §§ 13-2310, 13-2311.

⁷⁷ A.R.S. § 13-2301 *et seq.*

⁷⁸ A.R.S. §§ 13-2314 and 13-2314.04.

⁷⁹ A.R.S. §§ 34-222 and 41-2574.

⁸⁰ See *REM Constr. v. Houghton*, 162 Ariz. 322, 783 P.2d 261 (Ct. App. 1989).

⁸¹ Because these business entities are all created by statute, strict compliance with statutory requirements is necessary to create them. An entity that is not validly formed and in existence may not have the ability to enter into a binding contract; therefore, the contract may be void or voidable.

⁸² A.R.S. § 38-431.05.

⁸³ See generally *Business Fin. Serv., Inc. v. Butler & Booth Dev. Co.*, 147 Ariz. 510, 711 P.2d 649 (Ct. App. 1985); *Pleasant v. Arizona Storage & Distrib. Co.*, 34 Ariz. 68, 267 P. 794 (1928); RESTATEMENT

material breach is so serious it goes to the heart of the contract. Violation of a term that was not central or essential to the contract will not usually justify termination.⁸⁴

Generally, a material breach occurs when the breaching party has either anticipatorily repudiated the contract,⁸⁵ or when the breaching party's performance has been so unsatisfactory or dilatory that the breach is significant. A minimal delay or minor variation in performance is not considered a material breach.⁸⁶ Furthermore, any breach must be the fault of the breaching party, not the party seeking to terminate the contract.

§ 3.3.4.3.1 What Is a "Material" Breach

A material breach occurs when one party fails to perform a substantial part of the contract, or one or more of the contract's essential terms or conditions, or fails to complete the work in a good and workmanlike manner, or if the breach substantially defeats the purpose of the contract. If the owner entrusts the contractor with funds for the specific purpose of paying for construction, and the contractor fails to perform the work and uses the funds for its own, unrelated purposes, that conduct would justify a termination and may result in criminal charges for theft by conversion as well as breach of fiduciary duty.⁸⁷

§ 3.3.4.3.2 What Is Anticipatory Repudiation

For anticipatory repudiation to occur, the repudiating party must unequivocally demonstrate to the other party that it has no intent to perform the contract.⁸⁸ The non-repudiating party is permitted to terminate the contract upon receiving notice of anticipatory repudiation and seek damages immediately.⁸⁹ If the contractor's actions are, in any way, equivocal, the non-repudiating party may not terminate.

(SECOND) OF CONTRACTS § 373(1); W. JAEGER, WILLISTON ON CONTRACTS § 1455 (3rd ed. 1959).

⁸⁴ *Eng v. Stein*, 123 Ariz. 343, 599 P.2d 796 (1979). For a case evaluating the sufficiency of the evidence to justify termination of a contract, see *Interstate Markings, Inc. v. Mingus Constructors, Inc.*, 941 F.2d 1010 (9th Cir. 1991). While the holding in the following case is tied closely to its unique facts and contract terms, it also held that non-compliance with an ambiguous contract term did not justify a default termination. *Pasco Indus., Inc. v. Talco Recycling, Inc.*, 195 Ariz. 50, 985 P.2d 535 (1998).

⁸⁵ *About v. DeConcini*, 173 Ariz. 315, 842 P.2d 1328 (Ct. App. 1992), *rev. denied*.

⁸⁶ *Pasco Indus.*, 195 Ariz. 50, 985 P.2d 535.

⁸⁷ *State v. Allen*, No. 1CA-CR 10-0517 (Ct. App. Apr. 14, 2011).

⁸⁸ *Snow v. Western Sav. & Loan Ass'n*, 152 Ariz. 27, 730 P.2d 204 (1986).

⁸⁹ *Kammert Bros. Enter., Inc. v. Tanque Verde Plaza Co.*, 102 Ariz. 301, 428 P.2d 678 (1967).

§ 3.3.4.3.3 Can the Owner Breach by Delaying Payment?

The owner can also breach the contract if it fails to make a progress payment to the contractor when due.⁹⁰ Indeed, the contractor may, in some cases, stop working if the owner fails to make a progress payment required by the contract, however, it is advisable to serve a written stop work notice pursuant to A.R.S. §32-1129.04 before suspending performance.⁹¹ The contractor may not, however, terminate the contract with the owner unless the failure to pay was a wrongful act; not just a minimal delay, or a delay that occurred because of a dispute over the amount due. The contractor must also perform all contractual requirements for receiving payment, such as getting the architect's certification of the pay application, delivery of lien waivers, and the proper documentation of payment applications.⁹² On the other hand, the contractor's failure to comply with all contractual documentation requirements for a payment application does not excuse the owner from providing a timely, written rejection or notice of disputed items in the payment application.⁹³ If the delay in payment materially impairs the contractor's ability to go forward, the contractor is justified in terminating the agreement.⁹⁴

When a progress payment is not made when due, a contractor may be entitled to suspend performance and wait for assurances of payment or actual payment itself.⁹⁵ If the contractor suspends performance while awaiting the progress payment, the contractor has not materially breached the contract or repudiated the contract.

If payment to a subcontractor is contingent upon payment to the prime contractor, the subcontractor may not be able to terminate the contract for cause.⁹⁶ If payment by the

⁹⁰ See, e.g., *Silliman Co. v. Ippolito & Sons, Inc.*, 467 P.2d 1249 (Conn. Ct. App. 1983).

⁹¹ *Angle v. Marco Builders, Inc.*, 128 Ariz. 396, 626 P.2d 126 (1981); see also *Pleasant v. Ariz. Storage & Distrib. Co.*, 34 Ariz. 68, 267 P. 794 (1928), *Greenlee Cty. v. Cotey*, 17 Ariz. 542, 155 P. 302 (1916); *Slaton Bros. SW, LLC v. Bozrah Builders, Inc.*, No. 1 CA-CV 10-0312 (Ct. App. Apr. 14, 2011) (unpublished) (written stop work notice advisable).

⁹² *Am. Cont'l Life Ins. Co. v. Ranier Constr. Co.*, 125 Ariz. 53, 607 P.2d 372 (1980) (contractor's failure to obtain architect's certificate authorizing final payment was denied balance of contract due upon completion).

⁹³ *Marana 670 Holdings, LLC v. Spirit Underground, LLC*, 2 CA-CV 2011-0136, 2 CA-CV 2012-0026, ¶¶ 9-13 (Ct. App. Oct. 1, 2012) (unpublished).

⁹⁴ See *Darrel J. Didericksen & Sons, Inc. v. Magna Water & Sewer Improvement Dist.*, 613 P.2d 1116 (Utah Ct. App. 1980).

⁹⁵ See *Hart & Son Hauling v. MacHaffie*, 706 S.W.2d 586 (Mo. Ct. App. 1986).

⁹⁶ The enforceability or application of these contingent payment clauses is hotly contested and, to a certain degree, governed by statute. See A.R.S. § 32-1129.02(A) (“[n]otwithstanding the other provisions of this section, performance by a contractor, subcontractor or material supplier in accordance with the provisions of a contract entitles the contractor, subcontractor or material supplier to payment from the party with whom the contractor, subcontractor or material supplier contracts.”)

owner is a condition precedent to payment to the subcontractor, the subcontractor usually may not terminate the subcontract without an extended period of non-payment or evidence of other material violations of the contract by the prime contractor.⁹⁷ Most states deem contractual provisions that provide for such contingencies not to be conditions precedent but merely a promise to pay at a time that is convenient and reasonable.⁹⁸ This conclusion should not be construed as an endorsement of contingent payment clauses.⁹⁹

§ 3.3.4.3.4 Can the Contractor Breach by Delaying Completion

Failure to complete a construction contract in a timely manner is not normally a material breach unless the contract specifically states that time is of the essence.¹⁰⁰ Merely designating a date and time for completion does not automatically make time of the essence in a building and construction contract.¹⁰¹ That does not mean, however, that the owner should seize upon the slightest delay as grounds for terminating the contractor.

Indeed, even if a construction contract contains a time is of the essence clause, a minor delay will probably not be considered a material breach justifying termination.¹⁰² Furthermore, if the contract contains a specific remedy for delay, such as a liquidated damage clause, the owner may have waived the right to terminate so long as the contractor has not totally abandoned the project.¹⁰³

If time is of the essence, failure to terminate may result in a waiver of timely performance. Such a waiver, however, does not entirely abrogate the owner's right to terminate. A further extension may only be for a reasonable time period.¹⁰⁴ Even when the contract contains no time is of the essence provision, the non-breaching party can still terminate for delay if the defaulting party has not performed within a reasonable time period. Of course, determining what is a reasonable time to complete the project depends on the type of contract, the work to be performed, and the effect of the ongoing delay in completion. There is no "bright line" rule of law establishing how much time is too much to complete the work, however, if the contract defines the conditions that must be satisfied to achieve

⁹⁷ This discussion is related to the topic of "pay-when-paid" or "pay-if-paid" clauses, which are more thoroughly explained in Chapter 3.2, Payment Arrangements and Retention Issues.

⁹⁸ See *Darrell T. Stuart Contractor of Ariz. v. J.A. Bridges & Rust-Proofing, Inc.*, 2 Ariz. App. 63, 406 P.2d 413 (1965).

⁹⁹ See *Hart & Son Hauling*, 706 S.W.2d 586.

¹⁰⁰ See *Zancanaro v. Cross*, 85 Ariz. 394, 339 P.2d 746 (1959).

¹⁰¹ See, e.g., *Schneider v. Rola Constr. Co., Inc.*, 183 N.Y.S.2d 955 (1959); *Byke Constr. Co. v. Miller*, 140 Ariz. 57, 680 P.2d 193 (Ct. App. 1984) (generally, a reasonable time period will be judicially applied where none is specified in the agreement).

¹⁰² But see *Zancanaro*, 85 Ariz. 394, 339 P.2d 746.

¹⁰³ See, e.g., *Vermont Marble Co. v. Baltimore Contractors, Inc.*, 520 F. Supp. 922 (D.D.C. 1981).

¹⁰⁴ See, e.g., *Dallas-Ft. Worth Regional Airport Bd. v. Combustion Equip. Assocs., Inc.*, 623 F.2d 1032 (5th Cir. 1980).

substantial completion, that definition will most likely control.¹⁰⁵ Therefore, great caution should be exercised before terminating a contractor for failure to perform within a reasonable time period.¹⁰⁶

Likewise, if the contract contains a certain date for completion, and the contractor is substantially complete¹⁰⁷ on that date, the owner must give the contractor reasonable additional time in which to complete the project before terminating the contract.¹⁰⁸ When the owner can mitigate the effect of delayed completion with money damages, termination may not be the most appropriate remedy.

§ 3.3.4.3.5 May the Owner or Contractor Demand Adequate Assurances That the Other Party Will Perform Its Contractual Duties

Often, a non-breaching party must determine whether the breaching party's conduct is sufficiently material to justify termination of the contract. Thus, when faced with a breach that appears material, the non-breaching party has the right to request—in writing—reasonable assurances that the other party will perform in accordance with the contract terms.¹⁰⁹ If those assurances are not provided, the non-breaching party may then have greater confidence that termination is justified.

For example, if a subcontractor is delaying performance, and the alleged reason for its delay is an inability to obtain supplies, the prime contractor can demand adequate assurances from both its subcontractor and the supplier that the supplies will be delivered and the work will be completed timely. The Uniform Commercial Code (U.C.C.), which applies to contracts for the sale of goods, authorizes a buyer or seller to request adequate assurances.¹¹⁰ Courts have applied this same reasoning outside the realm of contracts for the sale of goods.¹¹¹ Nonetheless, if a subcontractor's breach is caused in part by the contractor's actions, a court is unlikely to hold that an unanswered request for adequate assurances was sufficient grounds to terminate the contract.¹¹²

¹⁰⁵ *HCBeck, Ltd. v. PCCP CS Forum Portales Phase II, LLC*, No. 1 CA-CV 12-0353, ¶¶ 19-22 (Ct. App. June 13, 2013) (unpublished).

¹⁰⁶ See, e.g., *Lake Steel Erection, Inc. v. Egan*, 61 A.D.2d 1125, 403 N.Y.S. 2d 387 (1978).

¹⁰⁷ The term “substantial completion” has special significance in construction, and is often defined by contract. It generally means that the contractor has completed all major items of work required by the project, and the owner can use the project for the intended purpose even though some additional work remains to be completed. See AIA Form A201-2007, § 9.8.

¹⁰⁸ See *String v. Steven Dev. Corp.*, 307 A.2d 713. (Md. Ct. App. 1973).

¹⁰⁹ Cf. A201-1997, art. 2.2.1 (prime contractor's right to demand assurances of funds for payment from owner).

¹¹⁰ A.R.S. § 47-2609.

¹¹¹ See, e.g., *Markowitz & Co. v. Toledo Metro. Housing Auth.*, 608 F.2d 699 (6th Cir. 1979).

¹¹² See, e.g., *Westinghouse Elec. Corp. v. Garrett Corp.*, 437 F. Supp. 1301 (Ct. 1977).

§ 3.3.4.3.6 Can Failure to Satisfy Conditions Precedent Justify Termination

A construction contract may also be terminated if either party fails to meet an express condition precedent to the other party's duty to perform. For example, an owner may terminate a construction contract that is expressly made subject to zoning approval or adequate financing.¹¹³ These express conditions precedent will discharge a party's duty to perform the contract if they fail to occur. Arizona courts do not favor conditions precedent, so the contract must be very clear as to the requirements and effect of such conditions.¹¹⁴ If the condition precedent fails to occur, neither party is entitled to damages for the termination, because there has been no breach of contract.

§ 3.3.4.4 Requirement That Architect or Engineer Certify Default

As noted above, many construction contracts require the project architect or engineer to certify the prime contractor's default before the owner may terminate that contract. If the owner wants to accomplish an effective termination, it must comply with this requirement even if the contractor's default is undeniable. In part, this procedure has been adopted to protect architects and engineers from the consequences of a wrongful termination. Ideally, it will also provide some protection for the contractor from an owner who wants to terminate for some arbitrary and capricious reason. If the architect or engineer will not certify the grounds for a default termination, then the owner would not be justified in pursuing that option. In practice, however, the issuance of this certification is often a formality that is completed with little investigation or input from the architect or engineer.

This certificate must expressly state the grounds for the architect or engineer's conclusion that the contractor is in default, and a recommendation that the default justifies termination of the contract. The information in this certificate must be communicated to the defaulting contractor.¹¹⁵ The architect or engineer must exercise its professional judgment whether to include any factual justification for the termination recommendation.

From a risk management perspective, it is advisable to reference material, objective criteria in the contract that have not been met by the contractor—such as failure to complete the project on time or serious deviation from the plans—rather than rely on a summary determination that the contractor has defaulted.¹¹⁶ Good practice also dictates that the architect or engineer document the fact that it has previously notified the contractor and owner of these defaults and demanded corrective action. If the notice of

¹¹³ *Hastings & Chivetta Archs. v. Burch*, 794 S.W.2d 294 (Mo. Ct. App. 1990) (financing as condition precedent to payment for design services).

¹¹⁴ *Angle*, 128 Ariz. 396, 626 P.2d 126; *see also* *L. Harvey Concrete, Inc. v. Agro Constr. & Supply Co.*, 189 Ariz. 178, 939 P.2d 811 (Ct. App. 1997).

¹¹⁵ *American Continental Life Ins. Co. v. Ranier Constr. Co., Inc.*, 125 Ariz. 53, 607 P.2d 372 (1980); *see also* A201-1997, art. 14.2.2.

¹¹⁶ *See* sample notice of termination for default provided in Appendix 4 to this chapter.

termination is the first written notice to the contractor of its unacceptable performance, that decision may well be challenged as arbitrary and capricious, or not based on fact.

§ 3.3.4.5 Notice of Default and Opportunity to Cure

When notice of default and termination is required by the contract, failure to give adequate notice and opportunity to cure will usually invalidate the termination.¹¹⁷ Notice also provides the defaulting party an opportunity to mitigate any damages. When sending notice of termination to the defaulting contractor, the owner or general contractor must also notify the contractor's surety if a performance bond has been posted on the project.¹¹⁸ This gives the surety an opportunity to investigate the alleged default and take appropriate action to avoid a termination or promptly honor its bond if the original contractor is terminated. Failure to notify the contractor's surety of the default may release the surety from its obligations.¹¹⁹

For the notice of termination to be effective, it should probably state all material events of default, even though some courts have upheld a termination when the obligee has subsequently asserted reasons other than those contained in the notice as the grounds for termination.¹²⁰ The notice provision should also clearly express the reasons for the notice; *i.e.*, whether the notice period is to give the defaulting contractor an opportunity to cure its default, or merely to permit the contractor to shut down its operation and prepare to pull off the project. If the contract specifies that notice be directed to a particular person, or sent by particular means, those requirements should be honored to the greatest extent possible.

A sample termination for default notice is included as Appendix 6 to this chapter. It should be modified to suit the needs of a particular project and contract terms.

§ 3.3.4.6 Sufficiency of Notice

Although most contracts do not prescribe the form of a notice of default, the party issuing such a notice must ensure that the recipient understands the import of the notice. For example, a notice stating merely that the other party is in default and will be held liable for damages is not sufficient to terminate the contract.¹²¹ Any notice of termination for default must be direct and unequivocal to be effective; requesting the performance of additional work in this notice may make it ineffective as a termination.¹²² Termination of

¹¹⁷ *But see L.K. Comstock & Co. v. United Eng'rs & Constructors, Inc.*, 880 F.2d 219 (9th Cir.1989).

¹¹⁸ *See A.R.S. § 12-1641; see also Prescott Nat'l Bank v. Head*, 11 Ariz. 213, 90 P. 328 (1907).

¹¹⁹ *But see SCA Constr. Supply v. Aetna Cas. & Sur. Co.*, 155 Ariz. 281, 746 P.2d 22, *vacated*, 157 Ariz. 64, 754 P.2d 1339 (1987) (specific statute governing bonds on public projects prevails over general rule concerning sureties and joinder of principal may be waived in certain cases.)

¹²⁰ *See, e.g., New England Structures, Inc. v. Loranger*, 234 N.E.2d 888 (Mass. 1968).

¹²¹ *Moore v. Beisker*, 147 F. 367 (8th Cir. 1906).

¹²² *Marana 670 Holdings, LLC v. Spirit Underground, LLC*, 2 CA-CV 2011-0136, 2 CA-CV 2012-0026, ¶¶ 24-26 (Ct. App. Oct. 1, 2012).

the contract also does not excuse the owner from compliance with the Prompt Pay Act's requirement of timely rejection or notice of disputed items in payment applications submitted after the termination to avoid sanctions under the Act.¹²³

In those contracts that permit the owner or general contractor to take over the defaulting contractor or subcontractor's work, the notice must also notify the defaulting party of this election. The owner or contractor wishing to terminate a contract should consult legal counsel before taking that action so that justification and compliance with all contractual requirements can be confirmed, and the potential consequences fully evaluated. Such consultation may also yield other options to salvage the contract or mitigate the losses and delays associated with the termination and replacement of a contractor.

§ 3.3.5 Defenses to Termination

§ 3.3.5.1 Waiver

A party to a construction contract may waive its right to terminate by accepting late performance or any other performance after a material breach.¹²⁴ Waiver can be express or implied. An implied waiver occurs when the owner discovers or knows of a default or material breach but acts as if the contract is still in effect and permits the contractor to continue performance.¹²⁵ Even a government agency can be deemed to have waived its right to terminate a construction contract.¹²⁶

An implied waiver depends on the facts of the individual case. If, for example, the scheduled completion date has passed, but the general contractor continues to work on the project, and the owner permits the work to continue without objection, the owner will probably be deemed to have waived the contract completion date as cause to terminate the contract. If the owner wants to reinstate that term as grounds for default in the future, written notice to that effect should be given to the contractor. A sample notice is included at Appendix 7 to this chapter. It should be tailored to fit the circumstances of a particular case.

§ 3.3.5.2 Failure to Timely Exercise Option to Terminate

If the contract specifically states when the non-breaching party must exercise its option to terminate, then it usually must assert its right to terminate within the specified period. Otherwise, it may be estopped from exercising this right. If, however, the party owed performance does not accept any benefits of performance, it may still terminate the

¹²³ *Masaryk v. Mendelsohn Constr., LLC*, No. 1 CA-CV 13-0085 (Ct. App. Mar. 31, 2015) (unpublished).

¹²⁴ See 5 WILLISTON, CONTRACTS 683 (3d ed.).

¹²⁵ See, e.g., *Dallas-Ft. Worth Regional Airport Bd. v. Combustion Equip. Assocs., Inc.*, 623 F.2d 1032 (5th Cir. 1980).

¹²⁶ *Id.*

contract within a reasonable time. If the party to whom performance is due is induced by representations or promises that the work will be performed, and those representations or promises are not fulfilled, the party owed performance may still terminate when the default is confirmed.

§ 3.3.5.3 Exclusive Remedy in Contract

Quite often, construction contracts contain provisions that attempt to prevent a contractor or subcontractor from terminating the contract when certain conditions, such as delays, occur.¹²⁷ In *Michel & Pfeffer*, the subcontractor sought damages and the right to terminate because of a breach by the prime contractor. The contract contained language that a time extension would be the subcontractor's sole remedy for delays caused by the owner's neglect or default. The California Court of Appeals held that the subcontractor was not entitled to either damages or termination. Arizona courts have held generally that contractual remedies will usually control, but they will not be deemed exclusive unless the contract so states.¹²⁸ This issue has not been visited recently in Arizona appellate decisions, however, so courts may interpret such provisions in a manner that lessens the burden of their dockets.¹²⁹ Arizona's appellate courts have said on several occasions that they generally prefer to interpret contracts so as to avoid a forfeiture.¹³⁰

§ 3.3.5.4 Substantial Completion

Another defense that is often invoked when the owner or general contractor attempts to terminate a contract early is the doctrine of substantial completion. The law looks to the spirit of the contract, and not simply its terms, to determine whether a party has substantially performed its obligations.¹³¹

If minor defects exist in the construction, but the contractor has made a good faith effort to substantially perform the entire contract, it will be entitled to recover compensation under the contract for that portion of the work that was completed.¹³² On the other

¹²⁷ See, e.g., *Michel & Pfeffer v. Oceanside Props., Inc.*, 132 Cal. Rptr. 179, 61 Cal. App. 3d 433 (1976).

¹²⁸ *Zancanaro v. Cross*, 85 Ariz. 394, 339 P.2d 746 (1959).

¹²⁹ *Stevens/Leinweber/Sullens, Inc. v. Holm Dev. & Mgmt., Inc.*, 165 Ariz. 25, 795 P.2d 1308 (Ct. App. 1990) (court refused to enforce one-sided arbitration clause that gave owner alone option to initiate arbitration, holding that this provision lacked mutuality).

¹³⁰ *L. Harvey Concrete, Inc. v. Agro Constr. & Supply Co.*, 189 Ariz. 178, 939 P.2d 811 (Ct. App. 1997); see also *Schaeffer v. Chapman*, 176 Ariz. 326, 861 P.2d 611 (1993).

¹³¹ See *J.R. Sinnott Carpentry, Inc. v. Phillips*, 443 N.E.2d 597 (Ill. Ct. App. 1982).

¹³² *Cracchiolo v. Carlucci*, 62 Ariz. 284, 157 P.2d 352 (1945); see also *Smith v. Cont'l Bank*, 130 Ariz. 320, 636 P.2d 98 (1981) (where minor defects in construction could be repaired at reasonable cost, rescission not warranted).

hand, if the nature of the work is such that it is completely unusable in its unfinished state, the contractor may not recover payment for its partial performance.¹³³

Substantial completion is an equitable defense to termination. Therefore, the party asserting this defense must prove that it made an honest effort to perform; it acted in good faith; and it has not made any willful omission.¹³⁴ If the contractor intentionally used inferior material, the intentional omission will preclude use of the substantial completion defense, and the contractor will be held to have materially breached the contract.¹³⁵ If the breach is so minor that the contractor's substantial completion yields a structure or improvement fit for its intended purpose, the contractor may even be able to recover the full contract price.¹³⁶

Whether the contract has been substantially completed depends on a number of factors, including the terms and conditions of the contract and whether the construction meets the essential purpose for which it was planned. One factor that courts may use to determine if the contract has been substantially performed is the cost of repairing defects or omissions in relation to the contract price. For example, when the cost of repair is minimal in comparison to the contract price, a court may find that the contractor has substantially performed its obligations under the contract.¹³⁷

Similarly, if the only work remaining upon termination is a punch list of minor deficiencies noted after the owner has inspected the contractor's final work, the contractor is likely to recover for the work performed.¹³⁸ If the contract defines the conditions that must be satisfied to achieve substantial completion, that definition will most likely control.¹³⁹

¹³³ *Deck v. Hammer*, 7 Ariz. App. 466, 440 P.2d 1006 (1968) (well driller contracted to drill to depth of 1,000 feet but abandoned work after 700 feet; denied compensation for part performance because well was not usable by owner in its unfinished state).

¹³⁴ *Delta Constr. Co. v. Dressler*, 381 N.E.2d 1023 (Ill Ct. App. 1978).

¹³⁵ See *Canfield v. Reynolds*, 631 F.2d 169 (2d Cir. 1980).

¹³⁶ See *Weill Constr. Co. v. Thibodeaux*, 491 So. 2d 166 (La. Ct. App. 1986).

¹³⁷ See *Fluidair Prods., Inc. v. Robeline-Marthaville Water Sys.*, 465 So. 2d 969 (La. Ct. App. 1985).

¹³⁸ *Kubby v. Crescent Steel*, 105 Ariz. 459, 466 P.2d 753 (1970); *Mammas v. Oro Valley Townhouses, Inc.*, 131 Ariz. 121, 638 P.2d 1367 (Ct. App. 1981). While not directly on point, support for this position can be drawn from *Eng v. Stein*, 123 Ariz. 343, 599 P.2d 796 (1979), and *Gillespie Land & Irrig. Co. v. Hamilton*, 43 Ariz. 102, 29 P.2d 158 (1934). The RESTATEMENT (SECOND) OF CONTRACTS § 237 provides guidance in determining whether a contract is substantially complete.

¹³⁹ *HCBeck, Ltd. v. PCCP CS Forum Portales Phase II, LLC*, No. 1 CA-CV 12-0353, ¶¶ 19-22 (Ct. App. June 13, 2013).

§ 3.3.6 Remedies for Wrongful Termination

§ 3.3.6.1 Contractor's Remedies

If a prime contractor or subcontractor is wrongfully terminated, it has four alternative remedies available:¹⁴⁰

1. It may rescind the contract and recover in *quantum meruit* for the reasonable value of its performance to date.¹⁴¹
2. It may keep the contract in force and seek damages plus the contract price.¹⁴²
3. It may treat the breach as a termination of the contract and sue for profits it would have realized from performing.¹⁴³
4. It may waive the other party's breach and accept payment received as full performance.¹⁴⁴

The contractor's choice of remedy will depend upon how far performance of the contract has progressed. If a breach is not material, the contractor's only remedy is to continue performance and seek damages caused by the breach.¹⁴⁵

§ 3.3.6.2 Owner's Remedies

If the owner terminates the contract for default, the owner has four alternative remedies available:

1. It may accept the work in place and abandon the balance of the contract.

¹⁴⁰ *W. Pinal Family Health Ctr., Inc. v. McBryde*, 162 Ariz. 546, 785 P.2d 66 (Ct. App. 1989), see also *County of La Paz v. Yakima Compost Co., Inc.*, 224 Ariz. 590, 233 P.3d 1169 (Ct. App. 2010), which held that the remedies for breach of contract are rescission, continued performance with recovery of damages, or termination with recovery of damages. For a general discussion of remedies available for breach of a construction contract, see *Remedies in Arizona for Breach of a Construction Contract: American Continental Life Insurance Co. v. Ranier Construction Co.*, 22 ARIZ. L. REV. 1090 (1980).

¹⁴¹ *Spitalny v. Tanner Constr. Co.*, 75 Ariz. 192, 254 P.2d 440 (1953), *overruled in part on other grounds*, *Schwartz v. Schwerin*, 85 Ariz. 242, 250, 336, P.2d 144, 149 (1959); see also *Murdock-Bryant Constr., Inc. v. Pearson*, 146 Ariz. 57, 65, 703 P.2d 206, 1214 (Ct. App. 1984); *aff'd in part and rev'd in part*, 146 Ariz. 48, 703 P.2d 1197 (1985); and *Watts Constr. Co. v. Cullman County*, 382 So. 2d 520 (Ala. 1980).

¹⁴² In *Woliansky v. Miller*, 146 Ariz. 170, 172, 704 P.2d 811, 813 (Ct. App. 1985) the court of appeals held that a party who elects specific performance may also be awarded equitable damages when specific performance doesn't provide complete relief.

¹⁴³ *All Points Towing, Inc., v. City of Glendale*, 153 Ariz. 115, 735 P.2d 145 (Ct. App. 1987) (towing company entitled to recover lost profits after city's termination of its contract).

¹⁴⁴ See also *Earven v. Smith*, 127 Ariz. 354, 621 P.2d 41 (Ct. App. 1980) (nonconstruction case restates three options available to nonbreaching party under Arizona law).

¹⁴⁵ *Eng v. Stein*, 123 Ariz. 343, 599 P.2d 796; see also *Zancanaro v. Cross*, 85 Ariz. 394, 339 P.3d 746 (1959).

2. It may complete the work itself.
3. It may hire another contractor to complete the work.
4. It may allow the defaulted contractor's surety or guarantor (if any) to take over the contract and complete construction.

In addition, the owner may recover damages, including any excess costs of completion and damages due to delays in completion.¹⁴⁶ Regardless of whether the owner or another contractor finishes the project, the owner must take reasonable steps to minimize any additional completion costs, or the defaulting contractor may claim that the owner failed to properly mitigate its damages.¹⁴⁷

Even when a contract is not terminated for default, the owner may still recover damages resulting from the contractor's refusal or failure to complete the work within the specified time. The owner is entitled to actual damages caused by the contractor's delay absent a liquidated damage provision. These damages include extended overhead cost such as keeping a government inspector on the job after the specified completion date.¹⁴⁸

§ 3.3.6.3 Contractor's Damages

If the contract is wrongfully terminated or if the contractor stops work because of a material breach by the owner, the measure of damages depends upon the stage of completion. If the contract is wrongfully terminated before work begins, the measure of recovery is essentially lost profits; the contract price less the projected cost of performance. In addition, the contractor may be able to recover bid preparation and mobilization costs because they would constitute expectation and reliance damages.

If the contract is wrongfully terminated during the project, the contractor may recover the contract price, less the cost of completion, less any progress payments received. This again enables the contractor to recover its lost profits. Whether the contractor could recover its bid preparation costs, mobilization costs, and unabsorbed overhead depends on the facts of the case and whether the contractor was able to mitigate its damages by procuring other work. Detailed estimating and cost accounting data are essential to recovering the full measure of damages possible.

If the contract is wrongfully terminated when the work is substantially complete, in most cases the contractor will be able to recover the full contract price, less only any savings realized from the uncompleted portion of the work. Of course, if the contractor also was forced to perform extra work outside the scope of the contract, or it was delayed by circumstances beyond its control, it may be able to recover these damages as well. In

¹⁴⁶ See *HCB Beck, Ltd. v. PCCP CS Forum Portales Phase II, LLC*, No. 1 CA-CV 12-0353 (Ct. App. June 13, 2013).

¹⁴⁷ See *Marley v. United States*, 423 F.2d 324 (Ct. Cl. 1970), see also *Coury Bros. Ranches, Inc. v. Ellsworth*, 103 Ariz. 515, 446 P.2d 458 (1968).

¹⁴⁸ *Be&E Constructors, Inc.*, 67-1 B.C.A. (CCH) ¶ 6,239 (IBCA 1967).

addition to the regular contract remedies, a contractor may be able to recover interest payments it has made if it borrowed money specifically to perform the terminated contract. It may be able to recover unabsorbed overhead costs and reasonable post-termination costs. It may also recover winding up costs that were not included in the estimate because they were unexpected.

For example, an equipment rental contract may charge a premium for early return.¹⁴⁹ Of course, the owner may also be able to take certain offsets against the contractor's damages. These would include payments already made by the owner, and the value of any materials that the contractor has purchased that could be reused or resold.¹⁵⁰ The owner also is not liable for any costs incurred by the contractor's failure to mitigate after notice of the termination.

§ 3.3.6.4 Rescission and Restitution as an Alternative Remedy

There are four particular circumstances in which the contractor may choose to rescind the contract and seek restitution, rather than accept a wrongful termination:

1. When the contractor is losing money under the terms of the contract.¹⁵¹
2. When the contract has a "no damages for delay" clause or a liquidated damages clause that would be unfavorable to the contractor.
3. When the contractor would find it difficult to prove the expected profit for the job.
4. When the owner orders such material changes in the scope of work that they constitute abandonment of the original contract. In this case, total cost recovery would be more favorable to the contractor than attempting to prove entitlement to damages under the contract.¹⁵²

A contractor should not choose to rescind when the contractor's cost of performance would be more than the value conferred on the owner.¹⁵³

¹⁴⁹ See *Tull v. Gundersons, Inc.*, 709 P.2d 940 (Colo. 1985).

¹⁵⁰ See RESTATEMENT (SECOND) OF CONTRACTS § 347.

¹⁵¹ See RESTATEMENT (SECOND) OF CONTRACTS § 153, which permits rescission where a mistake results in an unconscionable situation, but § 154 of this Restatement acknowledges circumstances in which one party to a contract bears the risk of a mistake, either because that risk was assigned to that party by the contract, it assumed the risk by executing the contract knowing it had limited knowledge of the facts on which it was mistaken, or the court determines it is equitable for that party to bear the risk.

¹⁵² See *C. Norman Peterson Co. v. Container Corp.*, 172 Cal. App. 3d 628, 218 Cal. Rptr. 592 (1985) (and cases cited therein, and *J.A. Jones Constr. Co. v. Lehrer McGovern Bovis, Inc.*, 89 P.3d 1009 (Nev. 2004).

¹⁵³ See RESTATEMENT (SECOND) OF CONTRACTS § 344.

The contractor can prove that it would have earned a profit but for the owner's conduct and breach of contract. Jurisdictions differ as to the extent of a contractor's recovery for *quantum meruit*. The Restatement of Contracts states that allowing a contractor to recover all of its costs on a losing contract is "controversial."¹⁵⁴ Nonetheless, federal courts have held that a contractor's recovery is not limited to the contract price.¹⁵⁵ These courts held that the costs incurred by the contractor might be considered in determining the *quantum meruit* value of the benefit conferred. Even if the contractor is in breach, it may recover some compensation in certain cases.¹⁵⁶

§ 3.3.6.5 The Owner's Damages

If the owner terminates for cause during the course of construction, it may recover the difference between the cost of completion and the contract price. This is a standard contract remedy that permits the owner to retain a completion contractor or finish the project itself and recover any additional costs. Nonetheless the owner must act reasonably in completing the project to mitigate its damages. Usually, it is preferable to solicit multiple bids for completion to establish a fair value for the damages, although hiring a completion contractor on a "time and materials" basis may also be reasonable if completion work is modest or that is the only basis on which a reasonable replacement contractor would do the work.

If the project is substantially complete when the owner terminates the contract, the owner may recover the costs of completing the project, less the unexpended contract price. If, however, the cost of completion or repair outweighs the benefits to the owner, the owner may only be entitled to damages measured by the project's diminution in value.¹⁵⁷

The owner may only recover the difference between the value of the construction as contracted for and the fair market value of the construction as built. This can substantially decrease the owner's recovery and the damages imposed on the defaulted contractor. Courts apply this rule to prevent economic waste.¹⁵⁸ Similarly, Arizona courts appear to

¹⁵⁴ See *id.* at § 373, cmt. d.

¹⁵⁵ See *United States v. Bldg. Rentals Corp. v. W. Cas. & Sur. Co.*, 498 F.2d 335, 338 (9th Cir. 1974); *United States ex rel. Susi Contr'g Co. v. Zara Contr'g Co.*, 146 F.2d 606, 610 (2d Cir. 1944); see also *New Pueblo Constructors, Inc. v. State*, 144 Ariz. 95, 696 P.2d 185 (1985).

¹⁵⁶ See *Smith v. Cont'l Bank*, 130 Ariz. 320, 636 P.2d 98 (1981); see also *New Pueblo Constructors, Inc.*; *supra*.

¹⁵⁷ *Fairway Builders, Inc. v. Malouf Towers Rental Co.*, 124 Ariz. 242, 253, 603 P.2d 513, 524 (Ct. App. 1979). But see *HCBeck, Ltd. v. PCCP CS Forum Portales Phase II, LLC*, No. 1 CA-CV 12-0353 (Ct. App. June 13, 2013) (owner entitled to recover cost of replacing entire floor, not just defective portion, due to inability to match edge condition and appearance of undamaged portion of floor).

¹⁵⁸ See RESTATEMENT (SECOND) OF CONTRACTS § 348(b) (Arizona follows this rule). But see *Blecick v. Sch. Dist. #18 of Cochise Cty.*, 2 Ariz. App. 115, 406 P.2d 750 (1965), *overturned on other grounds*, *Donnelly Constr. Co. v. Oberg/Hunt/Gilleland*, 139 Ariz. 184, 677 P.2d 1292 (1984) (court of

require that substantial destruction of the building to correct defects would be needed before the economic waste rule will bar a recovery of damages.¹⁵⁹ Moreover, the difference between the projected costs of repair and the reduction in value must probably be great.¹⁶⁰

If the contractor's material breach is delay in completing the project, the owner may be able to recover for extended duration and overhead costs incurred.¹⁶¹ Unless limited by the contract terms, the owner may also recover for loss of use caused by delayed completion. Loss of use for delay is measured by calculating the actual time to complete the project, less the contract time for performance, less any delays caused by the owner or other excusable delays. Loss of use damages are typically based on the rental value of the project as completed, regardless of whether rental of the property was ever intended.¹⁶² The owner may also be able to recover additional financing costs incurred due to the delay.¹⁶³ The owner may also recover lost profits if it can prove with reasonable certainty that it would have earned profits from using the facility but for the delay caused by the contractor and that the loss of profits was foreseeable to the contractor. As with all lost profit claims, especially for new businesses, these damages may be difficult to prove.

§ 3.3.6.6 Liquidated Damages

Although courts once viewed liquidated damage provisions with skepticism, they have now become a standard term in many construction contracts. They provide the owner and contractor certainty in the amount of damages that could be assessed, and eliminate the need to prove actual damages caused by delay, such as lost profits and loss of use values. Although liquidated damages provisions are worrisome to contractors, quite often the contractor's liability exposure will be reduced because of such clauses.¹⁶⁴ The liquidated damages must be a reasonable estimate of damages that the owner will incur if completion is delayed. Liquidated damages may not be a penalty. The prevailing party does not need to prove it suffered actual damages to recover liquidated damages.¹⁶⁵

appeals held in *Blecick* that contractor must prove affirmatively and convincingly that economic waste would occur).

¹⁵⁹ *Id.*

¹⁶⁰ See, e.g., *County of Maricopa v. Walsh & Oberg Architects, Inc.*, 16 Ariz. App. 439, 494 P.2d 44 (1972).

¹⁶¹ See RESTATEMENT (SECOND) OF CONTRACTS § 347(b).

¹⁶² See *Ryan v. Thurmond*, 481 S.W.2d 199 (Tex. Civ. App. 1972); but see RESTATEMENT (SECOND) OF CONTRACTS § 348.

¹⁶³ See *Elar Invest., Inc. v. Southwest Culvert Co.*, 139 Ariz. 25, 676 P.2d 659 (Ct. App. 1983).

¹⁶⁴ See, e.g., *Heinkel v. City of Corvallis*, 510 P.2d 579, 582 (Or. 1973); see also *Roscoe-Gill v. Newman*, 188 Ariz. 483, 937 P.2d 673 (Ct. App. 1996), which holds that liquidated damage provision is not subject to challenge based on inadequacy to compensate for actual damages.

¹⁶⁵ *Mech. Air Eng'g Co. v. Totem Constr. Co.*, 166 Ariz. 191, 801 P.2d 426 (Ct. App. 1989).

If such damages appear unreasonably large when they are claimed, even if they appeared reasonable at the time the contract was executed, a court may refuse to assess them. Liquidated damages may be assessed only for unexcused delays and the contractor's liability for them ends upon substantial completion or termination of the contract.¹⁶⁶ They continue to accrue if the owner does not terminate, and permits the contractor to continue working after the completion date has passed.

However, if an owner rescinds the contract, it may not be able to recover liquidated damages. Owners may also lose their right to liquidated damages if they fail to hold them back from their final payment to the contractor. Nonetheless, if the owner terminates, it may be able to recover liquidated damages for delay through the termination date, plus the additional cost of completion.¹⁶⁷ Some courts have held that liquidated damages can continue to accrue after termination.¹⁶⁸ If, however, the replacement contractor's delay in completion is unreasonable, the owner is not entitled to the liquidated damages for the portion of the delay that is attributable to the second contractor.¹⁶⁹

§ 3.3.6.7 The Owner's Use of Rescission and Restitution

Rescission is beneficial to an owner when completion of a project will be exceedingly costly, or it will have no value as built. Rescission requires that the owner return to the contractor the fair value of the work performed.¹⁷⁰ If a difference exists between the value of the work to the owner and its cost to the contractor, the restitution value will be the lesser of the two. If the project is of little value, this rule greatly benefits the owner, even if the cost to the contractor is great.¹⁷¹ Rescission is not beneficial to the owner when the work is acceptable but the contractor has a losing contract. In these situations, the owner could be held liable for the value of the completed work even if it exceeds the contract price. Furthermore, by rescinding, the owner may have to forego damages. Rescission is not permitted once the project has been completed, and the only remaining performance required is payment of the contract balance. Therefore if the contractor's performance is unsatisfactory, the owner should not wait until the project is complete to attempt rescission. Here again, unless a breach is material, the owner should not rescind, because he or she may be liable for wrongful termination.

¹⁶⁶ See RESTATEMENT (SECOND) OF CONTRACTS § 356 ¶ 1; *Heinkel*, 510 P.2d 579.

¹⁶⁷ See *Spinella v. B-Neva, Inc.*, 580 P.2d 945, 946 (Nev. 1978); *Lawson v. Durant*, 518 P.2d 549 (Kan. 1974).

¹⁶⁸ See *City of Boston v. New England Sales & Mfg., Inc.*, 438 N.E.2d 68 (Mass. 1982); see also *Spinella*, 580 P.2d 945 (1978).

¹⁶⁹ See *City of Boston*, 438 N.E.2d 68 (Mass.1982).

¹⁷⁰ See RESTATEMENT (SECOND) OF CONTRACTS §§ 371, 384.

¹⁷¹ *Id.* at § 371. See *Economy Swimming Pool Co. v. Freeling*, 370 S.W.2d 438 (Ark. 1963) (owner rescinded contract when fallout shelter leaked because concrete was honeycombed and one wall caved in, received restitution of down payment and discharged all materialmen's liens against home, and not required to make restitution to the contractor).

Rescission is an equitable remedy. The owner must act in good faith and with “clean hands” before it may rescind. If the owner provokes the contractor’s breach, a court is unlikely to allow equitable relief to the owner. If both the owner and the contractor materially breach the contract, each may recover its damages from the other (by means of set-off or recoupment) including damages for delay.¹⁷² The owner may also offset the costs the contractor has avoided by not completing the project.¹⁷³

§ 3.3.7 Termination for Convenience

Termination for convenience provisions are most often found in contracts with governmental owners.¹⁷⁴ Increasingly, private contracts such as the AIA forms have also adopted similar provisions.¹⁷⁵ In fixed priced government contracts, the termination for convenience clause provides [that the government may terminate the contract] “in whole or, from time to time, in part whenever the contracting officer determines that such action is in the best interest of the government.”¹⁷⁶ The only factor limiting the government’s right to terminate for convenience may be the requirement that the termination be in good faith.¹⁷⁷

In return for this unrestricted right to terminate, the government agrees to reimburse the contractor for all reasonable, allowable, and allocable costs connected with its performance, plus a reasonable profit as determined by government specifications. The government must compensate the contractor fairly for the work it has performed and for the preparations it has made for the work that is terminated. When the government

¹⁷² See *United States v. William F. Klingsmith, Inc.*, 670 F.2d 1227, 1230-31 (D.C. Cir. 1982).

¹⁷³ RESTATEMENT (SECOND) OF CONTRACTS § 347.

¹⁷⁴ FAR Subpt. 49.1 (concerning general principles applicable to terminations, including terminations for convenience of the government.)

¹⁷⁵ See AIA Form A201-1997, § 14.4, for example.

¹⁷⁶ FAR § 49.101(b).

¹⁷⁷ See *Torncello v. United States*, 681 F.2d 756 (Ct. Cl. 1982). Thus, even though the federal termination for convenience clause permits a contracting officer to terminate a contract whenever he or she determines that “such termination is in the best interest of the government” there may still be a necessity of good faith termination. In 1984, the United States Claims Court ruled that a specific finding of bad faith was not necessary to invalidate a termination for convenience. See *Municipal Leasing Corp. v. United States*, 74 Ct. Cl. 43, 47 (1984). In *Municipal Leasing*, the government sought to terminate the contract in order to obtain the product of another contractor, who had been considered at the time the government awarded the contract to Municipal Leasing. Circumstances had not changed since the initial award. The court held as follows:

[T]he termination for convenience clause can appropriately be invoked only in the event of some kind of change from the circumstances of the bargain or in the expectations of the parties. . . . The termination for convenience clause will not act as a constructive shield to protect defendant from the consequences of its decision to follow an option considered but rejected before contracting with plaintiff. See *Torncello v. United States*, 231 Ct. of Cl. 20, 681 F.2d 756 (1982).

terminates for convenience, the contractor's duty to perform ends and, accordingly, the government's obligation to pay for further work also ends. Once a contract is terminated for convenience, the government probably cannot bring subsequent claims for defects that were later corrected by other contractors. Indeed, even when the defects are not correctable, the terminated contractor may not be liable for those defects.¹⁷⁸

AIA document A201-2007 also provides that an owner may *suspend* the contract for its convenience.¹⁷⁹ This provision permits the owner to suspend, delay, or interrupt the work for whatever period of time it deems reasonable and necessary. Obviously, this right is balanced by the burdens imposed on the contractor; the suspension may not be indefinite. The owner must also make an equitable adjustment to the cost of the contract unless the necessity of suspending the contract was caused by the contractor. For example, if the owner suspends the contract and the contractor has already delayed performance, the contractor would not be entitled to recover damages for its own delay prior to the suspension.

Clearly, when an owner is considering terminating or suspending for convenience, it must ascertain in advance the cost of such a termination. If the work has been substantially performed in accordance with the contract provisions, the terminated contractor may be entitled to payment for all work actually performed even though the completed work contains defects.¹⁸⁰ The contractor certainly may claim it is not subject to offsets for defective work if it is precluded from remedying defects before the owner's unilateral termination. Likewise, the owner may have to cure defects in the work at its own expense when it terminates a contract for convenience.

In addition, unless the contractor's subcontracts contain the same termination or suspension for convenience language, the owner may be liable to the subcontractors for their termination damages as well.¹⁸¹ On private work, an unpaid subcontractor or materialman can assert liens against the project.¹⁸² Indeed, the *Pike* court held that the owner might be directly liable to an unpaid subcontractor for termination damages.

The federal government's right to terminate a contract for convenience is implied as a matter of law. The FAR provision cited above only formalized that right. Parties to a private construction contract must include a specific provision in the contract to permit termination for convenience. A termination for convenience clause gives one party, normally the owner, the absolute right to terminate the contract regardless of the reason for termination.

¹⁷⁸ See *Atlas Can Corp.*, 60-1 B.C.A. (CCH) ¶ 2,651 (ASBCA 1960).

¹⁷⁹ AIA Form A201-2007, § 14.3.

¹⁸⁰ See *Arc Elec. Constr. Co. v. George A. Fuller Co.*, 247 N.E.2d 111 (N.Y. 1968).

¹⁸¹ Cf. text of A401-2007, §§ 7.2.2 and 7.3 (termination or suspension for convenience of the owner).

¹⁸² See *Pike Indus., Inc. v. Middlebury Assocs.*, 436 A.2d 725 (Vt. 1980).

Since Arizona law implies a covenant of good faith and fair dealing in all contracts,¹⁸³ it is reasonable to assume that exercise of a termination for convenience clause would also be limited under state law by the duty to exercise good faith. But that does not mean, however, that the party attempting to exercise its legal right to terminate a contract must affirmatively prove its good faith.¹⁸⁴

While the Arizona Supreme Court would not characterize the outcome as a termination for convenience, it upheld a school district's decision to cancel the award of a construction contract before formal execution of the contract documents, even though the district's governing board previously voted to approve the award and a notice to proceed had been executed.¹⁸⁵

When a contract has been terminated for convenience, the federal procurement regulations permit the contractor to be made whole financially to recover compensation for the direct consequences of the government's termination. Negotiated termination settlements are limited only by the requirement of reasonableness and the original contract price. The federal construction contractor is entitled to the reasonable cost of its work; a fair and reasonable profit on the work completed; termination expenses including accounting, legal, and clerical costs for preparing a settlement proposal; the cost of settling terminating subcontracts; and project wind-down costs.¹⁸⁶ The contractor's right to recover a fair and reasonable profit may be limited if the government can demonstrate that the contractor would have lost money on the contract.¹⁸⁷ The contractor can only recover the profits on the work actually performed, not on the profits it would have earned from the entire contract.

The FAR termination for convenience clause also permits the contracting officer to terminate only part of the contract. The contractor can recover the same measures of damages for a partially terminated contract as it can for a wholly terminated contract. On federal projects, the partial termination settlement proposal must be submitted within 90 days after the effective date of the partial termination.

If the government contractor would have suffered a loss as a result of cost overruns, this loss is taken into account in any termination damages awarded to the contractor. The

¹⁸³ *Consumers Int'l, Inc. v. Sysco Corp.*, 191 Ariz. 32, 951 P.2d 897 (Ct. App. 1997), as amended January 6, 1998.

¹⁸⁴ *Id.*

¹⁸⁵ *Ry-Tan Constr., Inc. v. Washington Elementary Sch. Dist. No. 6*, 210 Ariz. 419, 111 P.3d 1019 (2005). Although overruled on other grounds, the court of appeals decision in *Ry-Tan* held that an owner may not terminate for convenience absent a change in circumstances that would justify its decision to do so. Where *Ry-Tan's* controlling fact—an un-executed contract—is not present, the court of appeals reasoning might be employed to overcome a wrongful termination for convenience.

¹⁸⁶ See 48 C.F.R. § 52.249-2 (1998) Alternate Contract Clause I.

¹⁸⁷ See *C.W. McGrath, Inc.*, 77-1 B.C.A. (CCH) ¶ 12,379 (GSBCA 1977).

burden of proving the reasonable and ordinary costs is judged by the standard of a prudent person in the conduct of a competitive business. The burden of proof is on the contractor to prove what these costs are. The contractor may not merely present its costs to recover them; it must also justify that its costs are reasonable. A contractor may not recover consequential damages after a termination for convenience.

§ 3.3.8 Mutual Termination by Agreement

In most instances, rescission is simply a form of termination in which either the parties mutually agree to terminate the contract, or where certain factors, such as impossibility, fraud, mistake, duress, or undue influence, permit one party to rescind the contract unilaterally. Rescission requires the rescinding party to restore the other party to the position that party was in prior to the contract.¹⁸⁸ Rescission can be oral or written.¹⁸⁹ For a rescission to be effective, both parties must agree.¹⁹⁰ To determine whether rescission has taken place, a court will look to the intent of the parties.¹⁹¹ If either party does anything that is inconsistent with rescission, the court is unlikely to find that such intent to rescind existed.¹⁹² Formal written notice of rescission is advisable.

In a key Arizona case involving rescission of a subcontract agreement, the court held that a subcontractor waived any right to sue for wrongful termination of the subcontract by agreeing to the takeover of its work by the general contractor.¹⁹³

Mutual abandonment is not the same as rescission. A rescission occurs when both parties mutually agree to end the contract. Abandonment occurs when one party commits a material breach of the contract and the other party refuses to continue performance. Abandonment is not a rescission because the non-breaching party has the ability to recover damages rather than restitution.¹⁹⁴

§ 3.3.9 A Termination Checklist

The following checklist for initiating or responding to a contract termination should not be considered exhaustive. Rather, it is meant to guide the owner, contractor, or their legal counsel in analyzing the issues presented by a termination scenario:

1. Review the contract and procurement rules to understand legal rights and procedures for terminating the contract.

¹⁸⁸ *Jennings v. Lee*, 105 Ariz. 167, 461 P.2d 161 (1969).

¹⁸⁹ *See Wippman v. Rowe*, 24 Ariz. App., 522, 540 P.2d 141 (1975).

¹⁹⁰ *See Love v. Double "AA" Constructors, Inc.*, 117 Ariz. 41, 570 P.2d 812 (Ct. App. 1977).

¹⁹¹ *See Bazurto v. Burgess*, 136 Ariz. 397, 666 P.2d 497 (Ct. App. 1983).

¹⁹² *See, e.g., Ed Bulliard Co. v. Foretich-Zimmer Constr.*, 451 So. 2d 29 (La. Ct. App. 1984) (subcontractor's order of windows after alleged oral rescission had occurred demonstrated no intent to rescind). *See also Diamos v. Hirsch*, 91 Ariz. 304, 372 P.2d 76 (1962).

¹⁹³ *Vinnell Corp. v. State ex rel. Bob Skousen Contractor, Inc.*, 15 Ariz. App. 576, 490 P.2d 21, *vac'd*, 109 Ariz. 87, 505 P.2d 547 (1971).

¹⁹⁴ *See C. Norman Peterson Co. v. Container Corp.*, 172 Cal App. 3d 628, 218 Cal. Rptr. 592 (1985).

2. Collect evidence of the other party's default or other grounds for terminating the contract.

- ☐ Records produced as the dispute unfolds, which accurately describe the owner or contractor's actions in handling the dispute, are often given great weight by a judge, jury or arbitrator.

3. When preparing a notice of termination, think about the underlying purposes for the notice:

- ☐ Commencement of contractual time periods for corrective action or penalties.
- ☐ Invitation to defaulting party to negotiate.
- ☐ Commencement of arbitration or litigation.
- ☐ Notice to a surety or insurer of potential or existing liability that triggers an obligation to perform or indemnify.
- ☐ Elimination of defenses to claim.
- ☐ Notice to other third parties affected by the termination; *e.g.*, subcontractors and suppliers.
- ☐ Preservation of a claim that may or may not be asserted at a future date.

4. The notice should specifically address the following points:

- ☐ The party to whom it is addressed. Where possible, a particular person should be identified as the addressee.
- ☐ The reasons for the notice of termination, if cause is required, or a statement that the contract has been terminated for convenience or some other good cause.
- ☐ The contractual terms or other legal justification for the termination.
- ☐ The specific action required from the terminated party.
- ☐ The time in which a response will be required (important in cases where liquidated damages, penalties, or other consequential damages are at issue).
- ☐ The consequences that will follow if the terminated party does not comply with the notice.

5. If an administrative claim, lien foreclosure, arbitration, or litigation are to follow, the contractor or owner should promptly notify legal counsel and begin collecting all documentation needed to pursue its claims.

- ☐ Submission or demand for arbitration.
- ☐ Change orders or back-charges.
- ☐ Lien waivers or releases.
- ☐ Insurance or surety bond claim forms.

- ☐ Notice of claim against governmental entity.
 - ☐ Complaint for the initiation of a lawsuit.
 - ☐ All relevant records should be collected, organized, and marked for retention pending resolution of the dispute. (This is especially important with companies that have multiple offices and/or records destruction policies.)
6. Notify all other affected parties of the termination, and request their assistance to secure the project.
- ☐ If the project is not complete, reasonable steps must be taken to secure it from theft, damages, obstruction, or deterioration. Likewise, any completion costs incurred must be reasonable, necessary, and documented.
 - ☐ No action should be taken that could be a waiver of the default, or inconsistent with the declaration of default.
7. Docket the expiration dates for statutes of limitation on claims or defenses.
- ☐ The time period allowed for claims against liability insurance may be set by the policy.
 - ☐ The time period for a claim against most bonds is also short; it may be dictated by statute or the terms of the bond.
 - ☐ By law,¹⁹⁵ a surety may demand that the party terminating for a default file a lawsuit to determine the extent of the surety's obligation, if any, for the claimed default. If suit is not filed within 60 days after the demand, the surety is released from all liability on the claim.
 - ☐ The surety can also be released from its obligations under its bond, if its principal agrees to an extension, renewal, or substantial modification of the underlying contract without its approval. Consequently, the surety's approval for any settlement should be obtained after a notice of termination is given.
8. Resolve claims by negotiation or proceed with litigation, arbitration or mediation to settle the dispute.
- ☐ Settlements, releases, change orders, extensions, and any other contractual agreements that might require legal action to enforce in the future should be put in writing and signed by all affected parties including insurers or sureties.

§ 3.3.10 Termination Scenarios

A few simple scenarios illustrate the principles discussed in this chapter. Following the description of the key factors on which a decision must be made, there is a recommendation whether the contract should be terminated, and whether alternative action might resolve the problem without making it necessary to terminate the contract.

¹⁹⁵ A.R.S. § 12-1641.

However, these termination scenarios are not a substitute for obtaining legal advice and using sound judgment before taking any action that may affect rights or liabilities.

Scenario No. 1: “Delayed but performing.” General contractor is three weeks behind schedule on a project with a 180-day contract time, but it has completed 90% of the project. It has about two weeks of work to complete before it will achieve substantial completion. The contractor and its subcontractors have fully staffed the project, and they are attempting to accelerate their work to make up some of the delay. The contract with the owner also contains a liquidated damage provision of \$1,500 per day for every day that the contractor is late in achieving substantial completion.

Recommendation: This situation does not justify a default termination. In fact, the owner might be liable for wrongful termination if it attempted to prevent the contractor from completing its work. The owner has an adequate remedy for the delay in its liquidated damage clause. The owner may be justified in requested assurances from the contractor that it is doing everything necessary to recover the lost time, or it may order the contractor to supply additional manpower to make up time on the project.

Scenario No. 2: “Subcontractor in trouble.” A subcontractor responsible for critical path work has not supplied sufficient labor to maintain the schedule despite repeated demands by the general contractor for supplementation. The general contractor has received calls from suppliers and lien notices indicating the subcontractor is not paying for its materials. An updated survey of the project shows that the subcontractor is over-billed, and it may not have sufficient funds left in its contract to complete its work.

Recommendation: After complying with any notice provisions in the subcontract, the general contractor may be justified in terminating the subcontract for default. If the subcontractor is bonded, the notice of termination (and any show cause notices that precede the notice of termination) must also be sent to the subcontractor’s surety.

Scenario No. 3: “Budget over-run.” Midway through the construction of a highway project, an unanticipated cost increase in a key material threatens to exceed the funds appropriated for the work. The highway department can only cover the material cost increase if it reduces the quantity of roadway paved on the project from the amount originally planned.

Recommendation: Given this material change in circumstances, the highway department may be justified to negotiate either a mutual termination of the contract, or cause a partial termination for convenience. The prime contractor and its subcontractor and its subcontractors will be compensated for the value of their work completed and reasonable termination expenses as provided in the contract term or standard specifications dealing with terminations for convenience of the owner.

Scenario No. 4: “Contest of wills.” Work is proceeding on the project but the contractor and project architect are embroiled in an ongoing dispute. The contractor has stated on several occasions that it intends to file large claims for additional compensation due for extra work allegedly due to defects in the architect’s plans and specifications for the project. The architect believes the contractor made an error in estimating the costs of the project, and is attempting to avoid a loss by submitting change orders for work that is

properly within its contract scope. The architect has countered the contractor's threats by stating that the contractor is incompetent, and it will never receive another contract with the owner.

Recommendation: This scenario illustrates the type of dispute-riddled project that could result in major litigation if an attempt is made to terminate the contract for default. Nor may the contractor unilaterally terminate the contract without the risk of being found in breach. Both parties should consult legal counsel and make certain they have good cause for taking action against the other before proceeding. Mediation or some other alternative dispute resolution procedure may provide a means to resolve the disputes on this project without making it necessary to invoke contract termination clauses.

Scenario No. 5: "No pay, slow pay". Work is proceeding on schedule on the project and the contractor has completed about 60% of its work. The owner has refused to honor change order requests submitted by the contractor for differing site conditions encountered during the excavation of the project, even though the architect has certified that the change orders are justified. The owner is also running 30–45 days late on paying progress payment applications on the project, and it has taken arbitrary deductions from those pay applications for reasons that the contractor does not accept. The financial impact on the contractor's cash flow has begun to affect other projects, and it is clear to the contractor that it will incur a loss if it is forced to complete the contract for the original price.

Recommendation: While the contractor may be justified to terminate its performance on this contract due to the owner's default, it should not take that action without establishing further justification for doing so. The owner's failure to pay for extra work, and its back-charges, may not be a material breach if it has a *bona fide* dispute with the contractor over those claims. The contractor should request reasonable assurances of the owner's ability to resume timely progress payments on the project, and attempt to resolve disputes over its claims and disputed back-charges before claiming the owner is in breach. The contractor should also advise the owner of the potential consequential damages caused by non-payment or slow payment on this project. If the owner fails or refuses to honor its contractual obligations, and the contractor can honestly say the owner's breach is material, then a default termination may be justified. Even so, the contractor should attempt to complete the project and then assert its contract or lien claims against the owner rather than abandoning the project. If nothing else, the contractor may be forced by the owner to litigate the issue of whether its termination was justified.

Scenario No. 7: "A day late and a dollar short." The contractor has all but abandoned the project, sending skeleton crews that are not sufficient to keep the work on schedule. The owner learns that suppliers for the project have placed the contractor on C.O.D. terms because it has exceeded its credit limits and failed to pay timely for prior purchases. The contractor's responses to repeated demands for additional labor and a recovery schedule have been evasive at best. The architect's representative also reported that a key subcontractor pulled off the job for nonpayment, and the replacement subcontractor has not been maintaining the quality standards or schedule required by the project. The contractor posted a performance and payment bond at the start of the project.

Recommendation: If the contractor does not respond suitably to written notice of deficiencies and demand for cure, the owner may terminate the contract for cause according to its terms. Notice of the termination should be delivered to both the contractor and its surety, and the owner should demand prompt action by the surety to complete the project. The owner must cooperate with the surety in allowing a reasonable opportunity for its investigation and proposal of an appropriate method to complete the project.

Scenario No. 8: “Let’s part friends.” The contractor has mobilized its forces and commenced grading and excavation work. The owner has had difficulty getting permits issued and commencement of the building construction has been delayed significantly. The contractor is incurring additional costs due to the delay, and it has another project to start that will also be impacted by the delay.

Recommendation: This scenario may prove to be suitable for a mutual termination of the contract by negotiation with the owner. Ordinarily the owner is responsible for obtaining permits or other authorizations needed for the contractor to commence its work. If the contractor can spare the owner unnecessary expense by terminating the contract before either party has incurred significant expense from the mobilization, that may yield a good result for all concerned.

Appendix 1

Notice of Excusable Delay

[Name of Contracting Officer]

[Agency Name and Address]

Re: [Contract Name and Number]

Dear _____:

[Alternative paragraph 1: Event causing delays in completion]

We are writing to advise you that, on **[date delay event occurred]** we encountered circumstances causing a delay in the completion of this project which were not reasonably foreseeable to **[name of contractor or subcontractor]** or subject to our control. Specifically, the performance of our work, and that of our subcontractors on this project, was hindered and delayed by **[describe nature of delay event]**. We presently estimate that this delay will justify a **[number of days]** time extension on this project. We also anticipate that we will incur additional costs of approximately \$ _____, due to this delay. We will prepare and submit an itemized change order request for this delay event under separate cover.

[Alternative paragraph 2: Damage to completed work]

We are writing to advise you that, on **[date delay event occurred]** we encountered circumstances causing damage to completed work, and a delay in the completion of this project, which were not reasonably foreseeable to **[name of contractor]** or subject to our control. Specifically, on **[date]** severe and unexpected weather in the vicinity of the project caused heavy storm water run-off across the area in which we were working. This run-off, in turn, caused damage to the falsework supporting concrete forms, and made it impossible to move heavy equipment across the project until the soil dried out sufficiently to support the load. We are presently repairing this damage and examining the falsework and completed portions of the project to assure that we can safely re-start concrete placement.

We presently estimate that this delay will justify a **[number of days]** time extension on this project. We also anticipate that we will incur additional costs of approximately \$ _____, due to this delay. We will prepare and submit an itemized change order request for this delay event under separate cover.

Appendix 2
Notice to Cure

[Name of Contractor]

[Contractor's Address]

Re: [Contract Name and Number]

Notice to Cure

Dear _____:

You are notified that the Government considers your **[specify the contractor's failure or failures]** a condition that is endangering performance of the contract. Therefore, unless this condition is cured within 10 days after receipt of this notice **[or insert any longer time that the Contracting Officer may consider reasonably necessary]**, the Government may terminate for default under the terms and conditions of the **[insert clause title]** clause of this contract.

Appendix 3
Notice to Show Cause

[Name of Contractor]

[Contractor's Address]

Re: [Contract Name and Number]

Notice to Show Cause

Dear _____:

Since you have failed to **["perform Contract No. ____ within the time required by its terms" or "cure the conditions endangering performance under Contract No. ____ as described to you in the Government's letter of" (date)]**, the Government is considering terminating the contract under the provisions for default of this contract. Pending a final decision in this matter, it will be necessary to determine whether your failure to perform arose from causes beyond your control and without fault or negligence on your part. Accordingly, you are given the opportunity to present, in writing, any facts bearing on the question to **[insert the name and complete address of the contracting office]**, within 20 days after receipt of this notice. Your failure to present any excuses within this time may be considered as an admission that none exist. Your attention is invited to the respective rights of the Contractor and the Government and the liabilities that may be invoked if a decision is made to terminate for default.

Any assistance given to you on this contract or any acceptance by the Government of delinquent goods or services will be solely for the purpose of mitigating damages, and it is not the intention of the Government to condone any delinquency or to waive any rights the Government has under the contract.

Appendix 4
Notice of Termination for Default

[Name of Contractor]

[Contractor's Address]

Re: [Contract Name and Number]

Notice Termination for Default

Dear _____:

We previously sent you a **[Notice to Cure or Show Cause Notice]** on **[date]** detailing certain deficiencies in your performance of the contract referenced above. You have not cured those deficiencies or otherwise demonstrated good cause why this contract should not be terminated. You are currently in default of your contract obligations in the following respects: **[State acts or omissions constituting the default]**

Accordingly, you are hereby notified that the Government has determined that your failure to perform is not excusable, and it has elected to terminate the above-referenced contract for default effective **[insert effective date of termination or state that it is effective “immediately”]**. You are directed to cease all operations on the project on or before the effective date of this notice, and to direct your subcontractors to cease their operations and prepare for demobilization.

The Government may elect, at its option, to purchase any remaining supplies on hand or partially-completed work against your account, but you will be held liable for any excess costs that will be incurred by the Government in procuring the completion of this contract by others. By copy of this notice, the Government makes demand on your surety to satisfy its obligations under the performance bond furnished for this project, and requests your surety to advise the Government whether it desires to arrange for completion of the work.

You have the right to appeal the Contracting Officer's decision under the Disputes clause **[clause number]** of the contract. The Government reserves all rights and remedies provided by law or under the contract, in addition to charging excess costs. The disbursing officer has been directed to withhold further payments to you under the terminated contract, pending further advice, which will be furnished to you at the earliest practicable time.

Appendix 5**Notice of Termination on Private Contract of Construction****BY EMAIL AND US MAIL**

[Name of Contractor]

[Address of Contractor]

Re: [Name of Project]

Dear _____:

We are writing to notify you of our decision to terminate your contract for the construction of **[name and location of project]**.

The decision to terminate **[name of contractor]** on this project was made after due consideration of the numerous instances of default in your company's performance of its contractual obligations; failure to advance construction beyond **[phase of work or performance milestone]** even though the majority of the Contract Time fixed by **[contract clause]** of your agreement has elapsed; and your company's failure to account for the use of project funds and other defaults both major and minor in nature.

Our decision to terminate is supported by the certificate of the project architect, pursuant to **[contract clause]** of the contract. A copy of his written statement of grounds for termination is enclosed and incorporated by this reference. While **[name of architect]** has touched on most of the major defaults that justify this termination, his letter is not intended to be exhaustive of the grounds for termination.

Based on our own review of your company's performance on this project, and information provided to us by **[name of architect]**, we believe your company has committed the following events of default under the contract. This list of defaults is intended to be representative but not exhaustive of all grounds for termination: **[Note: following list is only illustrative; modify as needed.]**

1. Failure to prosecute the work to completion within the allotted Contract Time. The scheduled completion date, per **[contract clause]**, is **[date]**. **[Contract clause]** provides that time is "of the essence" and that you have agreed to the Contract Time as a reasonable allowance for the work required. Your company has not requested or justified any time extensions under **[contract clause]** of the agreement.

Based on the current state of the work, this completion date will not be met. This default is material and prejudicial in three respects: First, our occupancy of the residence will be delayed until **[date]**. Second, due to this delay, we will be forced to re-negotiate the terms of our construction loan, and we may incur higher costs

in doing so. Third, delays in completing the residence may cause us to incur additional costs for construction.

2. Failure to supervise and direct the work using the contractor's best skill and attention, per **[contract clause]** of the contract. Your company has failed to manage this project in a manner to accomplish its timely completion and error-free construction.
3. Failure to account for use of our funds. As noted in **[name of architect]**'s letter, your company has failed to provide lien waivers for prior payments, and it has failed to account for **[description of funds]**. We know that these vendors have not been paid even though your company was provided with the funds to do so. We are also troubled by the fact that your firm certified **[description of work]** was complete in support of your payment application. Since this is not a true statement, your firm has not justified the advance of additional funds on the construction loan.
5. Failure to provide proof of insurance as required by **[contract clause]** of the Agreement.
6. Evident failure to retain subcontractors to complete the work in a timely and cost-effective manner, which is a violation generally of **[contract clause]** and the general contractor's implied duty to manage the project in a manner designed to achieve its intended purpose.
7. Failure to execute contracts with subcontractors previously engaged, resulting in a cost increase of more than **[dollar value]** over the original quotation from this subcontractor.

This termination is effective immediately upon your receipt of this letter. We expect to receive your complete cooperation in effecting a transition in management of this project to the contractor we retain to complete the work. At a minimum, your cooperation must include the following:

1. Your immediate acknowledgment of this termination.
2. An updated accounting for use of funds previously expended and those now claimed for the balance of work completed by your firm prior to termination.
3. Signed lien waivers for all labor and materials previously paid for by us.
4. All subcontracts or binding quotations for labor and material to complete the project.
5. The building permit and all plans, specifications, or other project records provided to you or created by your firm in the course of its work.
6. All other documents and records needed to complete this project.
7. All un-expended funds which have been entrusted to you. **[If the project is residential, you may use the two following sentences.]** Please note that Ariz. Rev. Stat. § 33-1005 provides that all moneys paid to your company by the owners for labor and materials on this project are held in trust for the benefit of your subcontractors and suppliers. Those funds may not be diverted to any other

purpose. Under Ariz. Rev. Stat. § 32-1129 and § 32-1129.02, your company is obligated to pay promptly those subcontractors and suppliers who have completed their work to date.

Once you have provided the documentation and information requested in this letter, we will schedule a meeting with you to arrange for a final accounting and closeout of your contract. If any funds are owed your firm after allowing for those set-offs to which we are entitled due to your default, we will arrange for payment of those funds at that time. If the final accounting results in a finding that funds are due from your company, we will expect your further cooperation in remitting payment for such balance due.

Your prompt attention to this matter is requested. If you or your counsel have any other questions, please contact our attorney at your convenience.

Appendix 6
Notice of Default and Termination

CERTIFIED MAIL–RETURN RECEIPT REQUESTED

[Name of person to receive notice]

[Address to which notice is directed]

[Name of surety, if any]

[Address of surety]

Re: Notice of Termination For Cause - [Name of Project]

Dear _____:

This letter shall serve as notice that your contract for the project described has been terminated for cause effective on **[specific date or number of days after which default is final]**, unless, prior to that time, you have cured the specific events of default described in the balance of this letter. This notice is given pursuant to **[Contract term or section authorizing termination]** of your contract. No further notice or action need be taken to terminate this contract. The events of default listed in this letter are not intended to be exclusive, and we reserve the right to supplement this notice with evidence of other violations of your contractual requirements.

[Name of architect or engineer] has certified that good cause exists to terminate this contract (see enclosed copy of letter), for the following reasons:

1. **[Itemize events of default such as failure to adhere to schedule, failure to keep project free of liens, or defective workmanship]**
2. **[List all major grounds for terminating the contract.]**

You are hereby directed to vacate the project no later than the effective date of this notice of termination, and to turn over to **[name of our representative]** all plans, specifications, shop drawings, stored materials, and other materials needed to complete this project. By copy of this letter, we are also making demand on **[Name of surety, if any]** to remedy the consequences of this default termination.

No further payments will be disbursed to you until the project has been completed and all additional costs and damages due to your default have been collected. You **[and your surety]** will be responsible for payment of any additional costs of completion which are incurred due to your default.

Appendix 7
Notice of Waiver of Termination

CERTIFIED MAIL–RETURN RECEIPT REQUESTED

[Name of person to receive notice]

[Address to which notice is directed]

[Name of surety, if any]

[Address of surety]

Re: [Name of Project]

Dear _____:

This letter will acknowledge your correction of the deficiencies noted in my prior letter of **[date]** or your acceleration of performance to recover time lost due to inexcusable delays. Please note, however, that acceptance of your corrective action in this instance shall not amount to a waiver of your duty to comply with all terms and conditions of your contract in the future.

You are hereby notified that time is of the essence in your performance of this contract, and that strict adherence to all terms and conditions of this contract shall be required. Failure to complete your work within the contract time or any other deficiency in your performance may result in disciplinary action up to and including termination of your contract.