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FROM THE EDITOR:

This article, by [Jeff Reichard](#), of our Greensboro, N.C. office, addresses a recent Maryland decision on the application of a termination for convenience ("T/C") clause. Such clauses have been around for years, but the case law has generally come from federal contracts, and the courts that have construed them have given the federal government broad latitude in justifying a termination for convenience. The new Maryland rule could be the beginning of a new standard for use of the T/C clause in commercial contracts.

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TERMINATION FOR CONVENIENCE: A New Interpretation

By: Jeffrey M. Reichard

Introduction

The highest court in Maryland recently held that a termination for convenience clause in a construction subcontract cannot be invoked by a contractor for any reason it chooses, even though the express language of the contract seems to indicate that it can. Instead, the terminating contractor must have a reasonable good faith basis for such termination that comports with the fair dealings and the reasonable expectations of the parties. This decision may have far-reaching implications in many jurisdictions, including the Carolinas.

Before discussing the case and its potential ramifications, a brief discussion of termination for convenience clauses is in order. Termination for convenience clauses originated in government procurement contracts during wartime to allow the government broad discretion to terminate contracts upon the end of the war. They are still used in many federal government contracts today that are governed by the Federal Acquisition Regulations. These contractual clauses were ostensibly intended

to allow the government to terminate a contract for any reason at all. However, in recent years, courts have begun to hold that the government cannot invoke a termination for convenience clause arbitrarily or in bad faith. Nevertheless, the federal government enjoys a very strong presumption that it has acted in good faith when it invokes a termination for convenience clause. Under that federal standard, the party challenging the government's position must show "well-nigh irrefragable proof" that the government acted in bad faith.

In the private sector, termination for convenience clauses are intended to allow a contracting party to terminate a contract without having to allege and prove a default on the part of the terminated party. However, the remedies available to a terminated contractor vary drastically depending on the particular language of the termination clause. For example, Article 14 of the AIA A201 - 2007 Standard Form of General Conditions and Article 7 of the AIA A401 - 2007 Standard Form of Agreement Between Contractor and Subcontractor allows the terminated contractor to receive payment for all costs incurred by reason of such termination, along with reasonable overhead and profit on the work not executed. Similarly, the ConsensusDOCS 200 - Standard Agreement and General Conditions Between Owner and Contractor requires that the parties negotiate a premium to be paid to the terminated contractor in the event of a termination for convenience. In contrast, most non-form contracts, like the contract in the case discussed below, only allow the terminated contractor to receive payment for the costs actually incurred *prior* to the date of termination. Therefore, a prudent contracting party should examine the remedies available under the termination for convenience clause before executing the contract and before deciding whether to terminate a contractor.

The Case

In *Questar Builders, Inc. v. CB Flooring, Inc.*, 978 A.2d 651 (Md. 2009), the Court of Appeals of Maryland held that a termination for convenience clause includes an implied duty to act in good faith and in accordance with fair dealings. In that case, Questar was a general contractor for the construction of multiple apartments and townhomes which subcontracted with CB Flooring for the installation of carpet on the project. After executing the subcontract, the interior designer amended the specifications, thereby requiring CB Flooring to submit a change order, which increased the price of the subcontract. Questar then solicited bids from a competing subcontractor, terminated CB Flooring for convenience before CB Flooring began its work on the project, and contracted with the competitor for the same work at a lower price. Like many industry standard subcontracts, the subcontract between Questar and CB Flooring provided that Questar could terminate CB Flooring "for

convenience" and merely reimburse CB Flooring for the reasonable value of work actually furnished to the project and stored or specially fabricated materials. Although Questar cited other reasons for the termination, such as subjective doubts regarding CB Flooring's ability to adequately perform its obligations under the contract and CB Flooring's alleged overpricing of the change order, Questar ultimately relied on the termination for convenience clause in terminating CB Flooring.

The Court of Appeals of Maryland held that even though it was not contained in the express language of the subcontract, a general contractor must have an objective good faith basis for invoking a termination for convenience clause. Subjective doubts regarding a subcontractor's ability to perform were not sufficient reasons to terminate for convenience without an objective basis to substantiate those doubts. In particular, the court stated that the contracting party may terminate the subcontract for convenience only if it determines that "continuing the Subcontract would subject it potentially to a meaningful financial loss or some other difficulty in completing the project successfully." *Id.* at 672. Therefore, the court held that Questar wrongfully terminated the subcontract simply to get a better bargain from another source through bid shopping.

Practical Considerations in the Wake of Questar

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Although the *Questar* case is not binding on courts in the Carolinas, it is possible that a North or South Carolina court would follow the *Questar* court and require a terminating contractor to show that it had a good faith, objective and reasonable basis for terminating the other party for convenience, even if the express terms of the contract do not contain such a requirement. Similarly, this same principle could apply to an owner which seeks to terminate its general contractor for convenience.

When an owner or contractor determines that it should terminate another contractor, it must first decide whether the termination is for cause or convenience. This determination will affect the termination process and the parties' respective rights and obligations. In certain circumstances, a termination for cause may be converted to a termination for convenience if it is later determined that there was no default or cause for termination. However, the inverse is not true. Some courts have found that a terminating contractor cannot subsequently convert a termination for convenience into a termination for cause in an effort to recover damages for breach of contract. Therefore, a terminating contractor or owner must first decide whether the termination will be for cause or convenience and strictly follow the procedures for termination in the contract.

Assuming the terminating party chooses to terminate for convenience, the party should assume that a court would apply an objective standard when analyzing the justification for the

termination. Thus, before terminating a subcontract for convenience, the contractor must be prepared to show an objectively reasonable good faith basis for the termination. "Any reason at all" is not sufficient under the new *Questar* standard. On the other hand, a terminated subcontractor should not simply accept the termination when the terminating contractor cannot set forth a good faith basis for the termination.

Although the *Questar* court did not specifically identify what is considered a good faith basis for terminating a subcontract for convenience, it did state that a termination for convenience clause is a risk-allocating tool that permits termination where the owner or contractor "determined that continuing with the Subcontract would subject it potentially to a meaningful financial loss or some other difficulty in completing the project successfully." *Id.* at 672. The *Questar* court further indicated that there are many objective factors that determine whether there is a good faith and commercially reasonable basis for termination for convenience. For example, terminating a subcontract to obtain better pricing from another subcontractor or to avoid a valid change order appear to be insufficient justifications for termination. The timing of the termination will also be taken into account. In *Questar*, the general contractor terminated the subcontractor before it began performing on the project. Consequently, the court cited the fact that the general contractor could not have reasonably evaluated the subcontractor's ability to perform its obligations under the subcontract and that the terminated subcontractor incurred substantial pre-construction overhead costs without reimbursement.

In summary, a terminating contractor must evaluate many factors before deciding to terminate for convenience. The failure to do so may give rise to a claim for wrongful termination or breach of the implied duty of good faith. The terminating owner or contractor must evaluate the impossibility of performance of the subcontract, the non-responsiveness of the subcontractor, the justifications for any change orders and any other changes in circumstances since the execution of the contract. If a terminating contractor is unable to objectively justify the termination for convenience, a court may impose substantial liability for wrongful termination.

Conclusion

Although the *Questar* case is not binding on courts in the Carolinas, a well-informed owner or contractor may want to assume that the implied good faith requirement applies to a termination for convenience clause. Therefore, a terminating contractor must evaluate the risks and circumstances that have arisen since the execution of the contract to determine whether it has a good faith and commercially reasonable basis to terminate for convenience. Conversely, a terminated contractor or subcontractor should not simply accept a termination for convenience if the terminating party is

unable to provide a reasonable good faith basis for the termination.



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