

CONSTRUCTION AND THE LAW IN TEXAS

Point/Counter-Point: Subcontractor Default and Termination

The second article in this series addressing common construction disputes involves termination. For this article, I will address a scenario where a general contractor is considering terminating a subcontractor from a large scope of work. The column will address the considerations, potential risks, and commonly adopted positions of the parties in these disputes. Bear in mind when reading this column, the example used is a dispute between a general contractor and a subcontractor. The considerations addressed below can easily translate up or down the contractual ladder.

As I stated in last month's column, the idea is to provide you with food for thought relating to these disputes more so that delving deeply into the mechanics of the dispute. Part of the reason for this strategy in the column is because every contract or subcontract and every dispute has unique facts that must be considered in working through whatever contested items exist between the parties.

Scenario:

A subcontractor who has contractually agreed to perform a large scope of work on a project, approximately 20 per cent of the contract value, is not performing to the contractor's satisfaction. The source of the default is material based on the options the contractor may select for handling the performance default.

Depending on whether the subcontractor is involved in a scope dispute or delaying the progress of the job, the contractor's considerations for addressing or correcting the default vary. Another factor that will certainly come into play involves the amounts remaining on the subcontractor's contract.

This directly affects the contractor's ability to cover itself financially and must be evaluated in addressing the risk and exposure to the contractor with respect to available and selected remedies.

Typically, resolution of a scope dispute can be accomplished with a directive and a reservation of rights, thereby leaving the dollars in dispute to be addressed at the end of the job. Sometimes, these disputes involve changed conditions that necessarily involve the owner in a negotiated or mediated resolution. Other times, these disputes involve differing interpretations of the subcontract and contract documents that can be resolved between the contractor and subcontractor without involvement of others.

If, on the other hand, the dispute involves delay, failure to pay suppliers, or another material breach that causes concern that the subcontractor's default may derail the entire project or so adversely affect it that the contractor must evaluate the termination option, then the contractor should likely consider termination.

If the subcontractor is not bonded, the initial determination the contractor must make is whether sufficient funds remain in the subcontract to complete the work that will remain following termination either through self-performance or through a replacement subcontractor. If the subcontractor was required to procure a performance bond, then the theoretical assurance that the surety will pay any overage often provides comfort to a contractor facing this decision.

As an initial counter-point, and to explain my use of the word theoretical above, it must be understood that in many performance disputes that rise to the level

of termination involve disputed facts and allegations of wrongful termination by the defaulted subcontractor. In such a situation, the defaulted subcontractor's surety is entitled under the law to the same defenses as the subcontractor. Because the surety's performance obligation under the bond is prefaced on the presupposition that a proper termination following default has occurred, if there is cause to dispute the propriety of the termination and subsequent demand for performance, most sureties will deny performance and require the contractor to litigate the dispute before paying on the claim, if at all.

When a contractor is facing productivity concerns because of a subcontractor's delay, the initial course is to typically place the subcontractor on notice that any liquidated damages the contractor incurs from the owner will be passed on to the subcontractor and back-charged from the contract. However, this threat, even if exercised, often does not fully compensate the contractor for the impact the delayed subcontractor causes on a job.

This concern is relevant because a contractor might have a greater exposure to damages than initial appearances. As such, a decision to try and ride it out and force performance might ultimately cost the contractor more than anticipated and potentially leave it in a situation where recovery is unattainable from the defaulted and potentially under-capitalized subcontractor. A post-completion suit against the subcontractor without the backing of a surety may be economically useless.

Further, a subcontractor who is allowed to proceed, ultimately performs its scope of work, and sees a completion without the imposition of LDs, will certainly feel entitled to full contract sum without any offsets. If the contractor limited its notice to the offset of potential LDs, the subcontractor would have a very compelling argument against any withholding in front of a jury.

Because of the anticipated counterpoints to the contractor's likely arguments, a contractor facing a defaulting subcontractor must take into consideration a number of factors when determining the most effective, economically efficient, and appropriate response. In summary, a contractor should evaluate the following facts in arriving at its decision:

1. Egregiousness/depth of perceived default
2. Economic status of Project and the subcontract
3. Capitalization of defaulted



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A Balanced Approach to Construction Law.

- subcontractor
4. Contrary position of subcontractor and persuasiveness of same
5. Availability/likelihood of surety performance
6. Ability to complete with own forces or replacement contractor
7. Effect of replacement work on schedule and quality of work
8. Election, if any, of available remedies
9. Likelihood and projected cost of dispute resolution/litigation
10. Collectability of award or judgment

Just from a very high level discussion available in this column format, it should be clear that virtually every dispute in which one party is considering termination contains many layers of factual and nuanced analysis. A termination decision is not one that should be taken lightly and there are many issues that must be considered in order to ultimately arrive at what will hopefully be the right decision. 🐼

