

TERMINATING A SUBCONTRACTOR

Pitfalls and Pratfalls

GREGORY M. COKINOS
COKINOS, BOSIEN & YOUNG
2919 ALLEN PARKWAY, SUITE 1500
HOUSTON, TEXAS 77019
(713) 535-5500

16TH ANNUAL CONSTRUCTION LAW CONFERENCE

March 6-7, 2003

TABLE OF CONTENTS

I. INTRODUCTION 1

II. THE GENERAL CONTRACT 2

 (A) Flowdown Provisions 3

 (B) Quality of Work 4

 (C) Delivery of Warranties 6

 (D) Timeliness and Delay Damages 6

 (E) Payments and Liens 7

 (F) Waiver and Estoppel Issues 8

III. THE SUBCONTRACT 8

 (A) Documentation is critical 9

 (B) The First to Breach 10

 (C) Opportunity to Cure 11

 (D) Measures of Damage 12

 (E) Consequential Damages 14

 (F) Delay and Liquidated Damages 15

 (G) Payment Issues 15

 (H) Waiver, Estoppel and Tort 16

IV. PUBLIC CONTRACTING AND SURETIES 18

 (A) Public Projects 18

 (B) Surety Issues 20

V. MISCELLANEOUS ISSUES 21

 (A) Default Converted to Convenience 21

 (B) Cross Default and Self Help 22

 (C) Bid Situations 23

 (D) Owner Interference and Quantum Meruit 25

VI. CONCLUSION 26

TERMINATING A SUBCONTRACTOR

Pitfalls and Pratfalls

pitfall: “A hidden or not easily recognized danger or difficulty.”

pratfall: “A fall on the buttocks; a humiliating mishap or blunder.”

Webster’s New Collegiate Dictionary, pp. 868, 896 (G. & C. Merriam Co. 1981). In the construction industry, there are few decisions to be made by a general contractor which are more problematic than whether or not to terminate a subcontractor. The intended scope of this article is to illuminate some of the legal and practical “pitfalls” involved in terminating a subcontractor and identify some legal or practical “pratfalls”.

I.

INTRODUCTION

In the context of a construction project involving subcontractors, a general contractor is routinely caught in the middle of the inherent tension between providing contractor-for performance to an owner and dealing with subcontractors who are contractually obligated to assist the general contractor in satisfying the owner. The owner may be reasonable or unreasonable. The owner may or may not have employed an architect. An architect’s plan may be good or poorly designed and he or she may be either reasonable or unreasonable with inspection and approval criteria. There may be a payment and performance bond surety to consider. Finally, there are considerations involved depending on whether the owner is a private or public entity. Ultimately, the general contractor is responsible for delivering the specified project for the specified amount at the specified time.

On almost every construction project, a general contractor retains a variety of subcontractors to perform the various scopes of work, including, structural, electrical, plumbing, roofing, cladding, heating ventilation and air conditioning and other innumerable trades. In a perfect world, each subcontractor performs the specified scope of work for the specified price in the specified time frame; the general contractor recovers its overhead and reasonable profit; the job is completed; and, the general contractor moves onto the next utopian project. There is no perfect worlds, however. General contractors and subcontractors routinely become embroiled in disagreements which become disputes giving rise to the general contractor’s need to determine whether the subcontractor should be terminated. Litigation often ensues.

When a general contractor (hopefully, with the assistance of counsel) is compelled to analyze whether a subcontractor should be terminated, there are essentially three sources of information available which should be thoroughly reviewed. First, there is the actual subcontract agreement between the general and subcontractor. Second, the general contractor should review the terms of its own contract with the owner. Finally, the general contractor should be aware of the overlaying application of Texas statutory and case law. Even if the general contract, subcontract and Texas law preponderate in favor of termination, the general contractor must still fall back on the most important and tangible aspect involved in deciding to terminate a subcontractor – is it the right thing to do? In other words, is the timing of the termination appropriate, are the financial aspects acceptable, is a case for termination documented, and will a jury find the decision to be reasonable.

In light of the above, this article will be divided into four sections. The legal and practical concerns implicated by the general contract with an owner will be discussed first. Second the legal and practical issues emanating from the terms of the subcontract will be examined. Third, this article will review public contracting and surety issues. Finally, this article will address the miscellaneous legal and practical considerations. One final point should be made before we begin. This article is merely food for thought. This article is neither an encyclopedia of legal citations nor a glossary of hard and fast rules. Each project, contract and case is different. Where appropriate, existing cases, codes and statutes will be cited. However, as the construction practitioner knows, the manner in which trial judges, juries and arbitrators react to contract provisions and project situations often times bring about resolutions which never appear in the Southwestern Reporters.

II. THE GENERAL CONTRACT

The general contractor's working relationship with an owner and the terms of the general contract are important considerations in determining whether a subcontractor should be terminated. These owner issues increase in complexity when an active architect is involved. In general, the owner's contract with the general contractor is designed to place the onus squarely upon the general contractor to deliver the specified project on time and on budget. Without regard to the quality of timeliness of a subcontractor's performance, the owner looks solely to the general contractor and its responsibilities under the general contract. Any problem with a subcontractor which rises to the level of consideration of termination is a signal of a project in trouble and places the general contractor at risk with the owner. Before deciding to terminate a subcontractor, a general contractor should be aware of the following pitfalls commonly found in a general contract.

(A) Flowdown Provisions

In a significant number of subcontracts, the general contractor requires the subcontractor to take on the same duties and obligations to the general contractor that the general contractor owes to the owner. Many general contracts require the general contractor to place this language in all subcontracts and a great many do not. Whether the owner requires a flowdown provision or not, if the general contractor places a flowdown provision in the subcontract, the general contractor should provide the subcontractor with a copy of the general contract with the owner. This is a simple and practical suggestion, however, as many practitioners know, during the hectic early days of a project, many subcontractors sign an agreement with a flowdown provision without ever asking to see the general contract. All too frequently, it is not until undesirable material starts hitting the fan that either the general contractor seeks to remind the subcontractor of his obligations or the subcontractor thinks to ask for a copy of the general contract. In many instances, it's too late.

Obligations imposed upon a subcontractor by virtue of a flowdown provision are generally enforced as long as the terms in the general contract are reasonably clear and specific. *LeBlanc, Inc. v. Gulf Bitulithic Co.*, 412 S.W.2d 86, 93-94 (Tex.Civ.App.–Tyler 1967, no writ ref'd, n.r.e.) (provisions only applied to general and not subcontractors); *Kessman & Associates, Inc. v. Barton-Aschman*, 10 F.Supp.2d 682, 692 (S.D.Tex. 1997) (forum selection and dispute resolution mechanism applied to subcontractor). However, while reported decisions appear consistent in this respect, many practitioners know a trial court is leery of imposing terms from the general contract upon a subcontractor who either was not provided with a copy of the general contract or more importantly, a subcontractor who requested a copy and was denied access to the general contract.

Therefore, if a general contractor is going to terminate a subcontractor for failure to comply with an obligation incorporated into the subcontract through a flowdown provision, the general contractor should make sure to document the act of providing the subcontractor with either a copy of or an opportunity to review the general contract at or near the time the subcontract is executed. The pratfall which could be experienced is a failure of the trial court to grant summary judgment on the issue and/or a jury panel, believing the situation to be unfair, declines to find breach on the part of the subcontractor.

(B) Quality of Work

“Obviously, if work is poor, someone must correct it to the owner’s approval.” Canterbury, *Texas Construction Law Manual*, § 7.41, p.291 (2d Ed. 1992). That “someone” is always the general contractor. As between the general and subcontractor on the issue of quality, two benchmarks for performance are involved: (1) the plans and specifications, and (2) industry standards.

The plans and specifications for the project are either directly provided to the subcontractor or incorporated into the subcontract by reference in almost all cases. *Hanger Gen’l Contractor v. Greater Winson Grove Baptist Church*, 597 S.W.2d 32 (Tex.Civ.App.–Austin, 1970, no writ) (reference to specifications incorporate them into contract). Obviously, when a subcontractor’s work continually fails to comply with clear specifications, a case for termination can be made. However, more often than not, the subcontractor will claim an inability to comply because of ambiguous or defective specifications, that industry custom overrides the specifications, or that the general contractor has waived compliance either explicitly or implicitly (waiver will be discussed in later sections, *infra*, pp. 8, 16-18). These situations are potential pratfalls.

First, consider the situation where the plans are either ambiguous or faulty. Further assume the subcontractor is terminated for failure to comply with the owner’s and contractor’s version of what the plans and specifications call for. If the subcontractor proves the plans were either ambiguous or faulty, the subcontractor will prevail on a wrongful termination claim. Where does this leave the general contractor vis-a-vis the owner and the general contract? The general contractor must keep these pratfalls in mind when the terms of the general contract and the plans and specifications of the general contract are formulated.

Two areas of the general contract which routinely come up in this request are the provisions with regard to a warranty of the accuracy of the plans as well as the provisions requiring the general contractor to review the plans and specifications for errors. There are two competing lines of cases in Texas. The more recent line or “Spearin Doctrine” holds the contractor is not responsible for defects resulting solely from design errors unless the contractor specifically assumes responsibility for the plans and specifications. *U.S. v. Spearin*, 248 U.S. 132 (1918); *Shintech, Inc. v. Group Constructors, Inc.*, 688 S.W.2d 144,151 (Tex.App.–Houston [14th Dist.] 1985, no writ); *Turner, Collie & Braden, Inc. v. Brookhollow, Inc.*, 624 S.W.2d 203, 207-208 (Tex.Civ.App.–Houston [1st Dist.] 1981), *aff’d in part, rev’d in part*, 642 S.W.2D 160 (Tex. 1982); *Board of Regents of the*

University of Texas System v. S&G Constr. Co., 529 S.W.2d 90, 95-96 (Tex.Civ.App.–Austin 1975, writ ref'd, n.r.e.).

An older line of case holds the owner only guarantees the sufficiency of the design. *Lonergan v. San Antonio Loan & Trust Co.*, 104 S.W. 1061, 1065-66 (Tex. 1907); *Emerald Forest Utility District v. Simonsen Constr. Co.*, 679 S.W.2d 51, 52-53 (Tex.App.–Houston [14th Dist.] 1984, writ ref'd, n.r.e.): *Ruberoid v. Scott*, 249 S.W.2d 256, 259-260 (Tex.Civ.App.–Dallas 1952, no writ). In the *Emerald Forest* case, the court held an inspection clause in the contract gave the contractor an opportunity prior to submission of its bid to discover the design of the system was insufficient and the failure of the engineer to consider all conditions of the work did not relieve a contractor from the obligation to deliver a working sewer system. *Emerald Forest*, 679 S.W.2D at 52-53. Therefore, before deciding to terminate a subcontractor because the quality of work is not in compliance with specifications, the contractor should ensure the plans and specifications are clear. If there is an ambiguity or defect, the issue should be identified as early in the project as possible or, if the plan or specification is obscure the matter should be addressed to the owner or architect first.

The other problematic area for a general contractor with respect to quality of work has to do with the more nebulous subject of industry custom. This issue usually arises where the plans and specifications are silent or in situations where the subcontractor claims to have complied with industry custom. See, *State v. F&C Eng'g. Co.*, 438 S.W.2d 647, 652 (Tex.Civ.App.–Houston [14th Dist.] 1969, writ ref'd, n.r.e.). There are many gray areas here. Where plans are silent and the subcontractor performs to what is described as industry standard, communication with the owner/architect is again critical. However, where the subcontractor is simply sloppy or the subcontractor is generally complying but falling victim to hypertechnical inspection processes or vague plans, the general contractor must be more careful. *Sands Motel v. Hargrave*, 358 S.W.2d 670, 673 (Tex.Civ.App.–Texarkana 1962, writ ref'd, n.r.e.). Where an owner representative insists on slavish adherence to immaterial specifications or insists upon unspecified testing so as to see the perfect project, the general contractor should be leery of terminating a subcontractor merely for failing to satisfy such an owner. The pratfall is a jury finding the subcontractor was wrongfully terminated and a judgement against the general contractor for the costs incurred by the subcontractor in trying to satisfy the owner - sometimes in excess of the value of the scope of the work. See, *State v. Buckner Constr. Co.*, 704 S.W.2d 837 (Tex.App.–Houston [14th Dist.] 1985, writ ref'd, n.r.e.) (total cost damages exceeded price of original scope).

(C) Delivery of Warranties

Many construction projects require the general contractor to deliver warranties to the owner at the conclusion of a project over and above the typical short term workmanship warranty. For example, an owner may require a general contractor to deliver a decade long warranty on a roofing system or a performance warranty on a cladding system, HVAC system or even the quality of something as mundane as a paint job. Where a general contractor is considering terminating a subcontractor who is to deliver an extended warranty, the general contractor needs to consider two related problems.

First, a defaulted subcontractor will not deliver a written and expressed warranty. Second, no completion subcontractor will warrant pre-existing work of a terminated subcontractor. Therefore, when the project is ultimately completed, there is no one but the general contractor to deliver the extended warranty. Most general contractors do not want this obligation – it can be expensive. Before terminating a subcontractor expected to deliver an extended warranty, a contractor must be satisfied there is a clear and material breach incapable of being cured.

(D) Timeliness and Delay Damages

On most sizeable construction projects, timely performance is often of paramount concern to the owner. While adequate provision in a general contract for delays caused by weather conditions or conditions of force majeure are not only standard but of great assistance, these provisions provide little help to the general contractor who puts up with a slow performing subcontractor. Where timeliness is critical, there is nothing more frustrating than slow performance by a trade subcontractor impacting the critical path of other important trade subcontractors. This is an area where constant monitoring and coordination as well as detailed paperwork is critical.

Many general contractors require the general contractor to properly coordinate the efforts of subcontractors so as to ensure the project progresses on a timely basis. The liability of a sitework subcontractor to perform stymies the entire project. The failure of a plumbing or electrical subcontractor to perform in a timely fashion can hold up the progress of other trades and so on. In these clear cut scenarios, the general contractor should address the issue as quickly, forcefully and clearly as possible. If the delay is clearly caused by inefficient and tardy subcontractor, resolution of the issue should occur sooner than later. The longer the situation continues, more time will be lost – time which cannot be made up by a replacement contractor. Failure to expeditiously resolve the issue

can result in a breach of the general contract and, in some cases, liquidated damages (*infra*, p. 15).

On the other hand, when confronted with late or delayed performance by a particular subcontractor, the general contractor must be mindful of the need to carefully review the reasons for delay. It may very well be that site conditions were not as specified; assuming timely processing by the general contractor, it may well be that the architect and owner are slow in responding to requests for information; it may well be that the plans and specifications are ambiguous or faulty (*supra*, pp. 4-5); and, it may well be that the true culprit for a subcontractor's delay is interference from another subcontractor.

The pratfall of the failure of the general contractor to judiciously resolve these issues will be a jury finding of wrongful termination and associated delay damages as well as the increased cost of delivering the job through a replacement subcontractor. More importantly, the project will not be delivered on time and could be subject the general contractor to breach or liquidated damages from the owner which it may or may not be able to pass onto the subcontractor. The general contractor may want to consider supplementing the subcontractor's work force to get the project on schedule. Dealing with a disputed backcharge is easier than starting over.

(E) Payments and Liens

Many general contracts require the general contractor to keep the project free of liens and hold the owner harmless against claims by third parties including subcontractors. Almost all general contracts more importantly require a general contractor to certify payment to all subcontractors before the owner is to pay a draw request or pay application.

Suffice it to say efficient monitoring of subcontractor activity includes careful review of the status of the work to ensure payment is made to the subcontractor only for work in place. If the general contractor does not realize the subcontractor has been overpaid until months after the fact, the only remedy may be to withhold payment on current pay applications. Typically, regardless of the truth or not of overpayment, the cash flow challenged subcontractor will begin the lien process and may in fact abandon the job. Abandonment of a project by an unpaid subcontractor at the wrong time can create havoc for the general contractor even if the subcontractor has in fact been overpaid.

Of course, the flip side is equally true. If a subcontractor has not been overpaid but is simply the victim of heavy-handed or arbitrary payment approval processes, the general contractor is exposed to a significant pratfall. Specifically, the subcontractor abandons

work for nonpayment and liens the job; the contractor is delayed in finding a replacement subcontractor; the project is delayed placing the contractor in default with the owner; and, the contractor must not only indemnify the owner against the lien but pay the subcontractor what it is owed at the end of the litigation process.

(F) Waiver and Estoppel Issues

In the context of the general contract, issues of waiver and estoppel typically arise in the context of change orders, extra work and quality of work. Most general contracts and subcontracts contain provisions requiring written authorization and agreement before commencing either extra work or change order work. To further refine the issue, a decision to terminate a subcontractor frequently involves a subcontractor refusing to work until being compensated for verbally authorized extra work or change orders. Typically, an issue has arisen on a jobsite and, in order to maintain schedule, the general contractor simply tells the subcontractor to do the work and don't worry about getting paid. Then, the general contractor finds out the owner is unwilling to pay anything more for extras or changes (rightfully or wrongfully) which leaves the contractor with the choice of honoring a verbal authorization or imposing a financial hardship on the subcontractor. *See, Nat'l Env. Serv. Co. v. Homeplace Homes, Inc.*, 961 S.W.2d 632 (Tex.App.–San Antonio 1998, no writ).

The simple answer (which is also hard to implement) is to immediately bring the need to discuss changes and extras with the owner as soon as a question is raised. By falling victim to the “string ‘em along” or “don't worry about it” theory, the general contractor is exposed to the pratfall of not only wrongful termination but being required to pay the extra or change order through waiver or estoppel and being unable to pass that payment along to the owner.

III. THE SUBCONTRACT

This section of the article will focus on the legal and practical considerations which flow from the agreement and relationship between the general and subcontractor which must be considered by a general contractor before terminating a subcontractor. In the preceding section, we discussed the manner in which a decision to terminate a subcontractor could be driven by the terms of the general contract as opposed to the terms of the subcontractor. When considering the terms of the subcontract in this section, many of the same legal and practical considerations discussed above will apply here. However, the focus is not so much on the impact termination of a subcontractor will have on the

relationship between the general contractor and the owner. Rather, the discussion will focus on the relationship between a general contractor and subcontractor and the legal pitfalls peculiar to that relationship. To the extent a particular pitfall and/or pratfall is identical, the topic will not be repeated in this section.

(A) Documentation is critical

While seemingly elementary, this consideration is the most consistently and often times overlooked element in a contractor's decision to terminate a subcontractor. This consideration impacts every legal and practical pitfall and most frequently leads to the undesirable pratfall.

Before a subcontractor is terminated (for whatever reason) it is imperative the general contractor completely document its dealings with the subcontractor from inception. If the subcontract contains a flowdown provision, document the delivery of a copy of the general contract to the subcontractor. If the plans and specifications are incorporated into the subcontract (as they invariably are), document delivery of the plans and specifications to the subcontractor. If the subcontractor is falling behind or providing substandard work, document these issues separately and in connection with regularly scheduled construction meetings. If the subcontractor complains of interference by other trades, document and investigate the complaint and document the results. If the subcontractor identifies the need for extra work or a change order, document the reason and the necessity even if it is impossible to document the amount of consideration to be paid, if any, for the extra work or change. When a subcontractor carries a performance bond, document notice to the surety contemporaneously with the events at hand. The list of instances is innumerable.

If the subcontract requires documentation, the issue becomes one of legal significance in an action for breach of contract. *Tex. Dept. of Transp. v. Jones Bros. Dirt & Paving, Inc.*, 92 S.W. 3d 477, 479 (Tex.App.–Dallas 2002, no pet.). More often the consideration of documentation is more of a practical pitfall. The ability to document a case for termination, clearly, consistently and repeatedly, is important to the credibility of the general contractor. As many practitioners know, juries will begin a case sympathizing with the subcontracting David rather than the financially superior Goliath of a general contractor. A well-documented case of legitimate reasons for termination is always preferable to a swearing match between a dark-suited general contractor's representative and a blue-jeaned good 'ole boy subcontractor.

(B) The First to Breach

One of the most consistently applicable legal pitfalls does not surface until litigation is commenced between a general contractor and a terminated subcontractor. Once litigation commences, the terminated subcontractor (through claim or counterclaim) asserts the general contractor was in material breach before the subcontractor was terminated. The first to breach analysis has two related ramifications. First, the failure of a subcontractor to comply with provisions of a contract may be excused by the unjustifiable failure of the general contractor to comply with binding provisions of the same contract. *Jordan Drilling Co. v. Star*, 232 S.W.2d 149, 159 (Tex.Civ.App.–El Paso 1949, writ ref'd, n.r.e.); *Argee Corp. v. Solis*, 932 S.W.2d 39, 45 (Tex.App.–Beaumont 1995), rev'd on other grounds; *Green Int'l v. Solis*, 951 S.W.2d 384 (Tex. 1997).

Second, if it is determined the general contractor breached the contract first, the general contractor can no longer rely upon contractual procedural rights and conditions concerning things such as change orders or claims for additional costs. *Tribble & Stephens Co. v. Consolidated Services, Inc.*, 744 S.W.2d 945, 950 (Tex.App.–San Antonio 1987, writ denied); *Shintech*, 688 S.W.2d at 151; *North Harris County Jr. College District v. Fleetwood Construction Co.*, 604 S.W.2d 247, 254 (Tex.Civ.App.–Houston [14th Dist.] 1980, writ ref'd, n.r.e.).

Common scenarios involving the first to breach analysis include withholding payment to a subcontractor based upon the latter's failure to satisfy an immaterial provision, *Texas Bank & Trust Co. v. Campbell Bros.*, 569 S.W.2d 35 (Tex.Civ.App.–Dallas 1978, writ dis'd); providing wholly inadequate plans and specifications, *Board of Regents*, 529 S.W.2d at 95-96; inadequate supervision, *Longview Construction & Development, Inc. v. Loggins Construction Co.*, 523 S.W.2d 771, 779 (Tex.Civ.App.–Tyler 1975, writ dis'd by agr); overly critical inspection procedures, *Buckner*, 704 S.W.2d at 840-02; failure to pay utility services required by contract, *Sage Street Associates v. Northdale Constr. Co.*, 809 S.W.2d 775 (Tex.App.–Houston [14th Dist.] 1991) *aff'd in part & rev'd in part*, 863 S.W.2d 438 (Tex. 1993); and, the wrongful attempt to construe covenant as a condition precedent, *Schwartz-Jordan, Inc. of Houston v. Delisle Constr. Co.*, 569 S.W.2d 878 (Tex. 1978).

An important aspect in the first to breach analysis is the nebulous concept of "material breach." Where the contract is silent whether or not a breach of contract is so material as to authorize termination or abandonment is a question of fact to be determined by the jury. *Advance Components, Inc. v. Goodstein*, 608 S.W.2d 237, 239 (Tex.Civ.App.–Dallas 1980, writ ref'd, n.r.e.); *Cowan v. Allen Monuments, Inc.*, 500 S.W.2d 223,

226 (Tex.Civ.App.–Texarkana 1973, writ des'd). In short, does the defect or condition go to the heart of the subject matter of the contract? A delay in performance by a subcontractor of one day can be material or immaterial. The failure to slavishly adhere to a specification could be material or possibly immaterial such as where performance is within industry tolerances where applicable. Again, documentation is critical.

Another problem occurs where the contract itself defines an event as a material breach. An argument to be anticipated is that a failure to comply with an unlisted event cannot be a material breach. This may or may not be true in practice. If the deficiency is not listed as material, the general contract should document the materiality of the issue as it arises. In order to uphold termination, the subcontractor must be in material breach. Otherwise, the general contract opens itself up to an embarrassing pratfall.

(C) Opportunity to Cure

Most subcontracts, whether they contain a flowdown provision or not, contain some type of provision giving a subcontractor the opportunity to cure a problem. However, even where there is no notice/cure provision in a subcontract, the general contractor contemplating termination of a subcontractor should, in almost every instance, notify the subcontractor of a defect or default and provide a reasonable opportunity to cure. The failure to give notice and an opportunity to cure has practical and legal pitfalls depending on whether the subcontract contains such an obligation. Obviously, if the subcontract specifically (or through a flowdown provision) requires notice and an opportunity to cure, the general contractor should comply completely with the terms of the contract. If the subcontractor is indeed in material breach and will most likely be unable to cure the deficiency, the notice of default and opportunity to cure provide potent insulation in subsequent litigation. In a less clear cut case involving a subcontractor with a repeated history of non-performance, a final notice of default and opportunity to cure should be a required pre-cursor to termination.

By the same token, in those contracts which do not contain notice and opportunity to cure language, from a practical standpoint, a notice of default and a reasonable opportunity to cure are extremely advisable. As previously stated, in litigation, the general contractor frequently must overcome the mind set of a jury which favors David over Goliath. Documented patience, fairness, courtesy and even-handedness are viable weapons for the general contractor seeking to substantiate the subcontractor's termination. Many subcontracts allow the general contractor, at its sole discretion, to determine whether the subcontractor's performance was adequate. If the general contractor gives notice of default or noncompliance and an opportunity for the subcontractor to cure, the general

contractor's decision with respect to a subcontractor's performance has a better chance of being upheld as a good faith determination when notice and opportunity to cure have been provided. *Black Lake Pipe Co. v. Union Construction Co.*, 538 S.W.2d 80, 88-89 (Tex. 1976). Finally, in lieu of a precipitous declaration of default, the general contractor may wish to consider other options to termination, such as the ability to supplement the subcontractor's work force. In many ways, these interim measures may save a project.

(D) Measures of Damage

In a close case, the general contractor must examine the appropriate measure of damage to evaluate the risk of an impending subcontractor lawsuit and the potential reward of recovering against the subcontractor for breach of contract. Much has been written on the appropriate measure of damage available to a general contractor or subcontractor in construction litigation. The applicable measure depends upon whether substantial completion has been achieved. The appropriate measure of damage also varies depending on whether the claim is one lodged by a contractor or subcontractor. The final consideration is whether the terms of the subcontract, specifically or through a flowdown provision, enumerate a measure of damage different than that available at common law.

When a subcontractor sues a general contractor and claims to have substantially completed the subcontract, Texas law is fairly clear. The subcontractor bears the burden to prove "substantial performance" failing which, the subcontractor cannot recover. *Dobbins v. Redden*, 785 S.W.2d 377, 378 (Tex. 1990); *Vance v. My Apartment Steakhouse*, 677 S.W.2d 480, 481 (Tex. 1984); *Atkinson v. Jackson Bros.*, 270 S.W. 848, 850 (Tex. Comm'n App. 1925, holding approved).

If the subcontractor is able to obtain a finding of substantial completion, the subcontractor is entitled to recover the full subcontract price less the reasonable cost of remedying any defects or omissions as to make the building conform to the contract. *Vance*, 677 S.W.2d at 482. Critically, in order to recover, the subcontractor bears the burden of proving the reasonable costs to repair or remedy. *Id.* at 482-83. Thus, the subcontractor must not only prove its damages but those of the general contractor in order to net out a recovery. *Vance*, 677 S.W.2d at 482-83; *Vance* 677 S.W.2d at 485-86 (Robertson, J., *concurring*); *citing*, *BPR Constr. & Eng'g., Inc. v. Rivers*, 608 S.W.2d 248, 249-50 (Tex.Civ.App.-Dallas 1980, writ ref'd, n.r.e).

What about the situation where substantial performance was clearly not achieved and the subcontractor contends it was wrongfully terminated by the general contractor? Texas law will allow a prevailing subcontractor to recover for part performance of the

entire contract if complete performance has been prevented by the other party. *Graves v. Sommerfield*, 618 S.W.2d 952, 954 (Tex.App.–Waco 1981, no writ); *Tex-Craft Builders, Inc. v. Allied Const. of Houston, Inc.*, 465 S.W.2d 786, 791 (Tex.Civ.App.–Tyler 1971, writ ref'd, n.r.e.). In this scenario, the subcontractor is entitled to recover for the unpaid portion of the work performed and, in addition, the balance of the contract price less the expenses which would have been incurred in completing performance (net profit lost). *McCracken Constr. Co. v. Urrutiai*, 518 S.W.2d 618, 620-21 (Tex.Civ.App.–El Paso 1974, no writ); *Tex-Craft*, 465 S.W.2d at 791. In defending against this claim and measure, documentation of deficiency and default is imperative.

The damages available to a general contractor are essentially those damages available to the owner in a claim against a general contractor. The general rule allows for the recovery of the cost to complete and/or the cost to remedy defects less the contract balance. *McKnight v. Renfroe*, 371 S.W.2d 740 (Tex.Civ.App.–Dallas 1963, writ ref'd, n.r.e.); *Bledso v. Bowden*, 411 S.W.2d 59, 60 (Tex.Civ.App.–Ft. Worth 1966, no writ). Going further, the contractor must establish the costs were reasonable and necessary. *Driver Pipeline Co., Inc. v. Mustang Pipeline Co., Inc.*, 69 S.W.2d 779, 785-86 (Tex. App.–Texarkana 2002, pet. filed). It is important to remember, the cost of repair and completion is measured by the subcontractor's scope of work and should not include betterment costs which are not recoverable. The subcontractor will have the burden to prove a betterment has occurred. See, *Pasadena State Bank v. Isaac*, 228 S.W.2d 127 (Tex. 1950); *Hollingsworth Roofing, Inc. v. Morrison*, 668 S.W.2d 872 (Tex.App.–Ft. Worth 1984, no writ); *Chemical Express Carriers v. French*, 759 S.W.2d 683, 689 (Tex. App.–San Antonio 1988, writ denied).

It is also important to keep in mind that if the cost of remedy and completion is too excessive, Texas law may impose upon the general contractor the difference in value measure to avoid economic waste. *Hutson v. Chambless*, 300 S.W.2d 943 (Tex. 1957). This measure awards the difference between the value of the project as built and its value had it been built in accordance with the plans and specifications. However, the subcontractor must raise the issue and provide evidence that the value method is more appropriate. *Greene v. Bearden Enterp., Inc.*, 598 S.W.2d 649, 652 (Tex.Civ.App.–Ft. Worth 1980, no writ). This measure seems to be unique to owners rather than general contractors and no cases were found imposing such a measure upon a general contractor.

Finally, the general contractor may have already contracted for a measure of damage. Because Texas courts will enforce clear language in a contract between the parties, it has been held, where the parties contract for the actual cost to complete, reasonable costs need not be shown. *Page v. Travis-Williamson County Water Control*

Impr. Dist. No. 1, 367 S.W.2d 307, 309 (Tex. 1963); *Fidelity & Deposit of Maryland v. Stool*, 607 S.W.2d 17, 23-24 (Tex.Civ.App.–Tyler 1980, no writ); *Tucker v. Northcutt*, 248 S.W.2d 750, 751 (Tex.Civ.App.–Waco 1952, writ ref'd). This type of measure is particularly appropriate where the subcontractor has willfully departed from the specifications. *Hutson*, 300 S.W.2d at 946 (Norvel, J., *concurring*); *Stool*, 607 S.W.2d at 22-23. *See also*, *Loggins v. Gates*, 301 S.W.2d 525, 528 (Tex.Civ.App.–Waco 1957, writ ref'd, n.r.e).

There are significant examples in Texas cases of situations where extensive repair costs were allowed due to extensive failures. *Southern Surety Co. v. Sealy ISD*, 10 S.W.2d 786, 789-90 (Tex.Civ.App.–Austin 1928, writ ref'd) (failure to follow specifications so prevalent as to allow owner to recover the cost of taking down and re-erecting brick facade around school); *Bledsoe*, 411 S.W.2d at 60 (paving so inadequate work had to be torn up and redone); *Winandy Greenhouse Constr., Inc. v. Gram Wholesale Floral, Inc.*, 456 S.W.2d 470, 474 (Tex.Civ.App.–Ft. Worth 1970, no writ) (improper construction methods required reinstallation of greenhouse roof); *Perry Roofing Co. v. Olcott*, 722 S.W.2d 538, 541 (Tex.App.–Ft. Worth 1986), *aff'd*, 744 S.W.2d 929 (Tex. 1988) (entire roof replacement necessary because simple repair would only cure known leaks); *Lebco, Inc. v. McGregor Park Nat'l Bank*, 500 S.W.2d 698, 704 (Tex. Civ.App.–Houston [14th Dist.] 1973, writ ref'd, n.r.e.) (parking lot).

(E) Consequential Damages

Many subcontracts, either specifically or through flowdown provisions, preclude the recovery of consequential damages. However, a great many contracts do not include such limitations. In Texas, the ability to recover consequential damages as a result of a breach turns on whether the damages are a reasonably foreseeable consequence of breach which might reasonably be supposed to have been within the contemplation of both parties at the time the contract was made. *Mead v. Johnson Group, Inc.*, 615 S.W.2d 685 (Tex. 1981); *Snyder v. Eanes ISD*, 860 S.W.2d 692, 698 (Tex.App.–Austin 1993, writ denied).

The general contractor contemplating the termination of a subcontract without limitation on consequential damages must evaluate the full measure of damages available to a subcontractor claiming wrongful termination. There are a myriad of consequential damage including, loss of collateral business profits, diminished bonding capacity, loss of goodwill and trade credit, amounts owed to a surety for payment bond claims where the general contractor has refused to make payment, and a variety of others depending on the imagination of subcontractor counsel. Sometimes the only defense to these consequences is the foundation – whether these type of damages could have been within the

contemplation of the parties. *Snyder*, 860 S.W.2d at 698; *Nelson v. Data Terminal Systems, Inc.*, 762 S.W.2d 744 (Tex.App.–San Antonio 1988, writ denied); *Texas Power & Light Co. v. Barnhill*, 639 S.W.2d 331 (Tex.App.–Texarkana 1982, writ ref'd, n.r.e.).

(F) Delay and Liquidated Damages

Most construction contracts contain some sort of provision precluding the recovery of damages for delay. Even the most carefully worded provision is susceptible to unenforceability or inapplicability. *Green Int'l v. Solis*, 951 S.W.2d 384 (Tex. 1997); *City of Houston v. R.F. Ball Constr. Co.*, 570 S.W.2d 75 (Tex.Civ.App.–Houston [14th Dist.] 1978, writ ref'd, n.r.e.); *Jensen Constr. Co. v. Dallas County*, 920 S.W.2d 761 (Tex.App.–Dallas 1996, writ denied). Therefore, before terminating a subcontractor, the general contractor must evaluate the potential exposure to delay damages sustained by the subcontractor and the extent, if any, to which the contract precludes such relief.

On the subject of liquidated damages, Texas law holds such damages to be enforceable against a subcontractor only if the stipulated amount is a reasonable approximation of the probable loss that will be caused by delayed performance and the damages caused by delay are difficult or impossible to determine. *Henshaw v. Kroenecke*, 656 S.W.2d 416, 419 (Tex. 1983); *Stewart v. Basey*, 245 S.W.2d 484, 486-87 (Tex. 1952). Otherwise, such damages are unenforceable penalty. *Loggins Constr. Co. v. Stephen F. Austin State Univ.*, 543 S.W.2d 682 (Tex.Civ.App.–Tyler 1976, writ ref'd, n.r.e.). It is also important to remember that occupation and/or substantial completion should stop the accrual of liquidated damages. *Travis-Williamson*, 376 S.W.2d, at 311; *Collier v. Betterton*, 29 S.W.2d 467, 468 (Tex. 1895). Additionally, some courts hold the imposition of liquidated damages is in lieu of actual damages and not in addition to actual damages. *Palmco Corp. v. Amer. Airlines Serv., Inc.*, 983 F.2d 681, 686 (5th Cir. 1993) (Texas law); *Eberts v. Business People Personnel Serv, Inc.*, 620 S.W.2d 861, 864-66 (Tex.Civ.App.–Dallas 1981, no writ). Perhaps the only sure method of recovering these damages from the subcontractor is where the general contractor is passing through a loss it has sustained to the owner as a result of the subcontractor's breach.

(G) Payment Issues

Payment issues do not typically give rise to a decision by the general contractor to terminate the subcontractor. However, payment issues always surface in subsequent litigation concerning the termination of the subcontractor. *Staff Industries v. Hallmark Contracting, Inc.*, 846 S.W.2d 542, 546-47 (Tex.App.–Corpus Christi 1993, no writ) (subcontract contended money due by industry custom). For example, the failure to make

timely payment without sufficient cause is a breach of the subcontract and may allow the subcontractor to abandon. *Citizens National Bank v. Vitt*, 367 F.2d 541 (5th Cir. 1966); *Fisher v. Richard Gilco*, 253 S.W.2d 915 (Tex.Civ.App.–San Antonio 1953, writ ref'd). See also, *B. Smith Contractors, Inc. v. Oshan Demolishing*, 877 S.W.2d 460 (Tex.App.–Houston [1st Dist.] 1994, writ denied).

Payment issues also arise when the contractor discovers the subcontractor has been overpaid for work actually performed. Many construction subcontracts contain provisions to the effect that payment for work does not constitute acceptance of work. While general contractors frequently rely on this provision in litigation with subcontractors, it is often surprising (but not unexpected) a trial will refuse to grant summary judgment on what appears to be a clear-cut contractual issues. See, *Anderson Dev. Corp. v. Coastal States Crude Gath'g Co.*, 543 S.W.2d 402, 406 (Tex.Civ.App.–Houston [14th Dist.] 1980, writ ref'd, n.r.e.) (final payment). Typically, overpayment is alleged to be a waiver or estoppel which are generally fact issues.

Finally, with respect to payment issues, it is important for the general contractor to keep in mind that nonpayment to a subcontractor may give rise to claims from the subcontractor's unpaid materialmen or suppliers. Regardless of the general contractor's justification for withholding payment to his subcontractor, the general contractor must keep in mind the unpaid suppliers and subcontractors who have lien or claim rights and, in some instances the ability to remove the material from the jobsite. See, *First National Bank v. Whirlpool Corp.*, 517 S.W.2d 262 (Tex. 1974); *P&T Mfg. Co. v. Exchange Sav. & Loan Assn.*, 633 S.W.2d 332 (Tex.App.–Dallas 1982, writ ref'd, n.r.e.). See, e.g., TEX.BUS. & COMM. CODE § 9.604 (Vernon 2002).

(H) Waiver, Estoppel and Tort

This consideration almost always flows from the general contractor's failure to follow the first consideration listed above – documentation. The manner in which waiver and estoppel claims arise permeate nearly all provisions of a subcontract including, quality of work, change orders, extra work, timeliness and delay. *Travis-Williamson County Water Control & Impr. Dist. No. 1 v. Page*, 358 S.W.2d 158, 168 (Tex.Civ.App.–Austin 1962); *rev'd on other grounds*, 367 S.W.2d 307 (Tex. 1963) (oral order of extra work and acceptance of benefit); *Tribble & Stephens*, 744 S.W.2d at 949-50 (general contractor directives precluded general contractor's reliance on written change order provision). *Baker Marine Corp. v. Weatherby Engineering Co.*, 710 S.W.2d 690 (Tex.App.–Corpus Christi 1986, no writ) (general contractor waived right to terminate subcontractor because of conduct during three month period between notice and termination); *Tex. Constr.*

Assoc., Inc. v. Balli, 558 S.W.2d 513, 521 (Tex.Civ.App.–Corpus Christi 1977, no writ) (conduct waived procedure in contract).

Although not generally susceptible to written appellate decisions, other examples of waiver and estoppel frequently arise during the construction process. For example, the failure to strictly enforce contract provisions and abide by non-compliant work could preclude the ability of the general contractor to terminate the subcontractor for failing to comply with the contract specifications. See, *Certain-Teed Products Corp. v. Bell*, 411 S.W.2d 596, 601-02 (Tex.Civ.App.–Amarillo 1966), *aff'd*, 422 S.W.2d 719 (Tex. 1968). Another example would be the situation where the general contractor carelessly but expressly allows the subcontractor to provide non-conforming work or material on the project only to have the non-conforming work or material rejected by the owner. See, *H.B. Zachry Co. v. Ceco Steel Products Corp.*, 404 S.W.2d 113, 128-30 (Tex.Civ.App. – Eastland 1966, writ ref'd, n.r.e.) (failure of general to pass on overtime claim of subcontractor known to exist in face of owner's objection to overtime). This is an example of an pitfall turning into a very embarrassing pratfall.

Finally, the general contractor needs to be aware that the inventive subcontractor counsel may be able to state a tort claim in addition to breach of contract. A few years ago the Texas Supreme Court squarely held a plaintiff may state a claim for fraud in the inducement notwithstanding the existence of a written contract between the parties. *Formosa Plastics Corp. USA v. Presidio Engineers*, 960 S.W.2d 41 (Tex. 1998).

Subcontractors may also be able to avail themselves of the tort of conversion of personal property where the general contractor takes possession of the subcontractor's property upon a termination later found to be wrongful. *Treble & Stephens*, 744 S.W.2d at 951-54. In this case, the general contractor claimed the contract allowed for it to take stored materials upon termination. However, since the general contractor breached first, the court held it could not avail itself of favorable contractual provisions. *Id.* at 952.

Similarly, where the general contractor has extensive contact with the suppliers and subcontractors of a defaulting subcontractor, it is not difficult to imagine a scenario where the subcontractor would attempt a claim of tortious interference with contract. Although no Texas cases were found where this argument was successful, the Texas Supreme Court does allow a tortious interference claim to co-exist with a breach of contract claim as long as the tort is independent of the breach. *American National Petroleum Corp. v. Trans-Continental Gas Pipeline Corp.*, 798 S.W.2d 274, 279 (Tex. 1990); see also, *Murray v. Crest Constr., Inc.*, 900 S.W.2d 342, 344 (Tex. 1995) (subcontractor lien did not tortiously interfere with general contractor's relationship with owner). Inasmuch as tort

claims may rise to punitive damages, the careful general contractor will evaluate the history of its dealings with the subcontractor and those dealing with the subcontractor in making a decision to terminate.

IV. PUBLIC CONTRACTING AND SURETIES

(A) Public Projects

Each of the issues discussed in the preceding two sections have similar application in the arena of public projects. However, as opposed to the private project, the general contractor on a public works project must be mindful of the various statutory protections provided to not only the owner but the subcontractors. The Miller Act, 40 U.S.C. § 270, *et seq.* (West 2000); the McGregor Act, Tex. Gov't. Code § 2253, *et seq.* (Vernon 2000). The obligations owed by the general contractor to a governmental owner must be considered along with Texas law when the general considers the prospect of terminating a subcontractor on a public job.

The principal concern for the general contractor on a public job is to maintain close watch on the performance of subcontractors. Here, it is not so much the decision to terminate the subcontractor as it is timeliness of the decision. For example, almost all public projects impose liquidated damages upon the general contractor for failure to timely complete the project. The longer a general contractor allows a subcontractor to deliver deficient or untimely work, the greater the general contractor's exposure is to delay damages on the one hand and the increased cost of performance incurred on the other when the subcontractor is terminated and a replacement subcontractor retained. These costs are difficult if not impossible to recoup.

More significantly, all governmental entities in Texas are protected to one degree or another by the doctrine of sovereign immunity. In contract cases, immunity from "liability" is waived by entering into a contract – immunity from suit is not. *Federal Sign v. Texas Southern University*, 951 S.W.2d 401 (Tex. 1997). Opinions concerning the stupidity or necessity of the sovereign immunity vary depending on the audience. Suffice it to say, in the public contracting arena, much has been written by the Supreme Court of late. *Texas A&M University-Kingsville v. Lawson*, 87 S.W.3d 518, 520 (Tex. 2002); *Texas Natural Resource Conservation Comm'n v. IT-Davy*, 74 S.W.3d 849, 853 (Tex. 2002); *Gen'l Serv. Comm'n v. Little-Tex Insulation*, 39 S.W.3d 591 (Tex. 2001).

Almost all municipalities, school districts and special purpose districts are enabled with language allowing them to “sue or be sued,” thus waiving immunity from suit. *See, e.g.* (Tex. Educ. Code § 11.062 (Vernon 1996); Tex. Trans. Code § 451.054(c) (Vernon 1999) (Metro); *Denver City ISD v. Moses*, 51 S.W.3d 386, 390 (Tex.App.–Amarillo 2001, no pet). Counties and most state agencies, including colleges and universities, retain immunity from suit. *Travis County v. Pelzel & Assoc. Inc.*, 77 S.W.3d 244 (Tex. 2002) (counties); *Federal Sign*, 95 S.W.2d at 404 (state university). Consent to suit is rarely given. *Federal Sign*, 951 S.W.2d 418 (Enoch, J., *dissenting*). Finally, certain state departments require mandatory arbitration or mediation to an in-house decision maker. In all these situations, the changes of recovering increased costs due to the general contractor’s delay in terminating a subcontractor are almost non-existent.

With respect to the general contract between a governmental owner and a general contractor as pertains to the decision to terminate a subcontractor, one other area must be explored. Specifically, municipalities, school districts and many governmental agencies are schooled in the mantra “We are stewards of the public’s money.” Moreover, the contracting representatives of governmental entities are low enough on the decision making chain they will not acknowledge errors, ambiguities or inconsistencies in plans. These representatives – whose jobs are at stake – will rarely accept blame on behalf of the entity for problems caused by the entity itself. Finally, contracting representatives of governmental entities will not approve extra work regardless of whether extra compensation is justified. They answer to a politically astute public works director or a politically motivated council or board looking to hold someone accountable for increased costs. There is no incentive to treat a contractor fairly much less deal with what they perceive to be petty claims of a subcontractor.

The overall lesson to be gleaned here is to closely monitor the work of subcontractors on public jobs. If the subcontractor falls behind or performs substandard work, document the situation thoroughly and copy the subcontractor’s performance bond surety on everything. If the subcontractor needs to be terminated, do so promptly. The chances of recovering the additional cost incurred in dealing with subcontractor problems is negligible. Therefore, the need to mitigate against these costs is imperative.

By the same token, if the subcontractor has identified problems requiring extra work or change orders, deal with the issue promptly. Delaying the inevitable confrontation with state, county, city or district representatives allows the subcontractor to be more inclined to abandon the job for nonpayment and expose the general contractor to a claim of breach by the government.

(B) Surety Issues

In deciding whether to terminate a subcontractor who is backed by a performance bond surety, the terminating general contractor needs to evaluate the history of the project and the subcontractor's performance if the general contractor intends to call upon the performance bond surety to complete the subcontractor's scope of work. Perhaps most importantly, the general contractor needs to be sure the surety was given notice of problems every step of the way through the project. Sureties frequently request status reports as jobs progress. The general contractor's response should be as accurate and candid at this stage as when problems arise.

In addition to the lack of or inadequate notice, sureties have a variety of other defenses available to them. For example, the surety may contend there was a material alteration or deviation from the underlying contract as an affirmative defense to liability under a bond. *Frost Nat'l Bank v. Burge*, 29 S.W.3d 580, 588 (Tex.App.–Houston [14th Dist.] 2000, no pet.); *see also, Old Colony Ins. Co. v. City of Quitman*, 352 S.W.2d 452, 453, 455 (Tex. 1961). There is also the potential the surety may contend matters were undisclosed during the course of the project or at the time the surety is called upon to take over. *See, e.g., St. Paul Fire & Marine Ins. Co. v. Commodity Credit Corp.*, 646 F.2d 1064, 1073 (5th Cir. 1981); *Goodwin v. Abilene State Bank*, 294 S.W. 883, 887 (Tex.Civ. App.–Eastland 1927, writ ref'd) (elements of the defense of failure to disclose).

Another defense which is possible that the general contractor failed to properly inspect the subcontractor's work before making payment on invoices. *See, Continental Ins. Co. v. City of Virginia Beach*, 908 F.Supp. 341, 348 (E.D.Va. 1995); *Vastine v. Bank of Dallas*, 808 S.W.2d 463, 464 (Tex. 1991) (surety bond only be precise terms of contract and not obligated to watch over contracting parties).

Another avenue frequently utilized by sureties is the claim that a "cardinal" change occurred on the project relieving the surety of obligation. Cardinal changes frequently occur where unanticipated issues arise which were not present when the contract was made. *Peter Kiewit Sons Co. v. Summit Constr. Co.*, 442 F.2d 242 (8th Cir. 1969) (cardinal change found were costs to backfill operations rose from \$600,000 to approximately \$2,000,000). A cardinal change can be as mundane as modifying the method of payment during the course of the constructed project. *United States v. Reliance Ins. Co.*, 799 F.2d 1382 (9th Cir. 1986). A fundamental change in the method of payment can discharge the surety whereas simple overpayment of the subcontractor may discharge the surety to the extent of the overpayment. *Nat'l Union Indemnity Co. v. G.E. Bass & Co.*, 369 F.2d 75, 77 (5th Cir. 1966); *City of Houma v. Municipal & Industrial Pipe*

Service, 884 F.2d 886 (5th Cir. 1989) (engineering firm liable to surety for negligence certification of progress payments).

There is an axiom that sureties are favorites of the law and their obligations will be strictly construed. *Standard Acc. Ins. Co. v. Knox*, 184 S.W.2d 612, 615 (Tex. 1944); *Augusta Court v. Levin, Roth & Kasner*, 971 S.W.2d 119, 123 (Tex.App.–Houston [14th Dist.] 1988, writ denied). While this axiom does not always prove accurate in practice, the careful general contractor should be sensitive to keeping the surety advised as the project progresses and thoroughly informed of any problems occurring with a troublesome subcontractor.

V. MISCELLANEOUS ISSUES

The last grouping of pitfalls to be considered will be a hodgepodge of scenarios which are either generally undecided or do not fit neatly in any of the categories listed in prior sections. Some of these areas of discussion do not necessarily involve a decision to terminate a subcontractor but do have an impact on the relationship between the contractor and subcontractor.

(A) Default Converted to Convenience

A great number of general contracts contain a provision authorizing the owner to terminate the contract for either default or for convenience. Many of these contracts are found to exist on public projects. Frequently, similar provisions are either specifically written into the subcontractor or they apply through a flowdown provision. In a close case where the general contractor is not necessarily convinced a strong case of termination for default can be made, can the general contractor terminate the subcontractor for default/breach and maintain the ability to convert the termination to one for convenience when the litigation takes an improvident turn toward the subcontractor? This is obviously a factually intense exercise.

The remedies available to a general contractor terminating a subcontractor for default are well established although the extent of the remedies vary by contract. The general theme is to provide a remedy to the contractor which places the contractor in as good a position had the contract been fully performed by the subcontractor – a more unilateral approach. On the other hand, termination for convenience clauses, although varying by contract, typically present a more bilateral approach. Specifically, termination for convenience clauses uniformly provide for compensation to be paid to the subcontractor

for the work in place at termination. *Baker Marine*, 710 S.W.3d at 694. Some of these clauses allow the subcontractor to recover lost dedicated overhead and the ability to recover costs for materials purchased but unincorporated into the job. The process is usually one of negotiation and compromise as there will inevitably be disputes concerning exactly what is in place. *Accent Builders Co., Inc. v. Southwest Concrete Systems, Inc.*, 679 S.W.2d 106, 109 (Tex.App.–Dallas 1984, writ ref'd, n.r.e.). The unilateral and bilateral approaches to the varying reasons for termination seem facially inconsistent.

In an ideal setting, the contract between the parties would specifically state that the automatic conversion of termination for default to termination for convenience is allowed. Reality dictates this rarely, if ever, happens. Thus, how is this result to be obtained? First, the general contractor's position should be clearly documented in both the pre-termination notice and the actual notice of termination. Second, the general contractor would be well advised to internally quantify not only its projected cost of completion by virtue of default but also to document its exposure to the subcontractor in a termination for convenience. Third, any litigation pleadings should consistently include this option as an alternative theory of the case. *Accent*, 679 S.W.2d at 109-10 (general contractor attempted to convert termination for convenience to default; absent prejudice general contractor entitled to jury issue). Obviously, to pull this conversion off, it must appear to be a well thought-out position as opposed to one taken out of anxiety over the strength of one's position as litigation progresses.

Furthermore, the circumstances under which a general contractor may wish to preserve the ability to convert termination from default to one for convenience would typically arise when the subcontractor has filed suit and the general contractor is preparing a counterclaim. In order to maintain the viability of termination for convenience as an option, the general contractor may want to consider making a tender under the convenience option early on in the litigation in order to potentially cut off additional attorney's fees incurred by the subcontractor. In all instances, the general contractor attempting this strategy should avoid laying behind the log on the issue and should threaten the possibility of invoking the strategy.

(B) Cross Default and Self Help

Many general contractors have a stable of subcontractors being utilized on more than one project at a time. To what extent may a general contractor terminate a subcontractor for default on one project and hold sums due the subcontractor on another project for security where there is no default on the second project? Many general contractors who make it a practice to utilize common subcontractors will typically place

a “cross default” provision in the subcontract agreement to allow for this practice. Many subcontracts do not contain these provisions and the general contractor simply resorts to the tactic as a measure of self help. *Williams Bros. Constr. Co. v. Glenn Fuqua, Inc.*, 1997 WL 82779 *7 (Tex.App.–Beaumont Feb. 27, 1997, no writ) (where general contractor rather than subcontractor is in breach, self help for offset fails).

As long as the subcontracts on the two projects in the hypothetical each provide for this remedy, it is reasonable to suppose a court would enforce the party’s agreement assuming the provision is clear and the parties were negotiating the contracts at arm’s length. Even so, it is not inconceivable that a court would be receptive to subcontractor arguments of unequal bargaining position or overreaching. Even though the general contractor should be aware of a trial court’s pre-disposition to protect against unfairness, the general contractor armed with a specific contractual provision on both projects should be relatively safe.

On the other hand, absent egregious circumstances, it is difficult to conceive of a scenario where a court would allow the general contractor to withhold sums due on one project to secure against the default of a subcontractor on another project where there is no contractual provision on the subject. For example, the trust fund doctrine requires the general contractor to utilize funds received on the project for that project alone. Tex.Prop.Code § 162.001, *et seq.* (Vernon Supp. 2003). The general contractor cannot comply with this aspect of Texas law by holding payments from the owner due a performing subcontractor hostage to secure against the subcontractor’s default on an unrelated job. *See, Id.* at §§ 162.031-.035. Thus, without more, it does not appear likely a Texas court would allow the general contractor to utilize self help measures in such a situation.

(C) Bid Situations

A great majority of bidding issues between general contractors and subcontractors are resolved before a formal subcontract is executed. For example, the subcontractor who, without making a bid mistake, demands to increase its price upon learning the general contractor got the job can be held liable under the doctrine of promissory estoppel and detrimental reliance for any overage incurred by the general if the subcontractor refuses to stick with its bid. *Traco, Inc. v Arrow Glass, Inc.*, 814 S.W.2d 186, 192 (Tex.App.–San Antonio 1991, writ denied).

On the other hand, when the subcontractor has made a bid mistake or blown its bid and notifies the general contractor several things can happen. The general contractor can

let the bidding subcontractor withdraw its bid; the general contractor could allow the subcontractor to fix its mistake and subcontract for the increased amount; or, the general contractor and subcontractor enter into a contract for the original bid. The first scenario may be the best, however, depending on the magnitude of the error, it may be difficult to find a replacement subcontractor for a price that will allow the general contractor to maintain its bid to the owner. The second scenario, again depending upon the magnitude of the error, involves bit of a gamble on the part of the general contractor. By taking this course, the general contractor accepts going in that the mistake will eat into its margin but hopes to make up the difference during the project through other subcontracts or by cutting its own costs. The third option is the more dangerous and the more prevalent.

Two factors usually combine to lead the subcontracting with a known bid mistake. Frequently, the subcontractor does not want to lose the job, is willing to run the risk and the general contractor is willing to let the subcontractor do it. At the same time, the general contractor not wanting, to lose a favorable bid or eat into its margins, cajoles the subcontractor into sticking with the mistaken bid amount by either promising or implying the subcontractor will not “take a bath” on the project or the general contractor will “make it up later.” This is a dangerous pitfall which almost always leads to a pratfall. When default occurs, the owner does not want to hear excuses or learn that the subcontractor made a bid mistake. The owner wants to know why the project has been delayed and his property liened by unpaid subcontractors and materialmen. Moreover, placing the blame squarely on the subcontractor will not work in the face of a waiver and estoppel claim asserted by the subcontractor. Therefore, if the subcontractor is willing to accept the contract with a blown bid, document this fact thoroughly and closely monitor the progress of the work.

Finally, there is the circumstances where a subcontractor has blown his bid and one of the parties is not aware of the fact. The easier situation is where the general contractor is wholly unaware of the blown bid. Here, the onus is squarely placed on the subcontractor. However, it is the situation where the general contractor is aware of the blown bid but the subcontractor is not that danger is presented. Blown bids invariably impact the project adversely. The general contractor who realizes the subcontractor has blown its bid should bring the mistake in the attention of the subcontractor promptly and, hopefully, before a mistaken bid is utilized. From the standpoint of case presentation alone, it is very difficult to wear a white hat when the evidence shows the general contractor knew about the mistake all along and opportunistically proceeds to subcontract with one who is unaware of the mistake.

(D) Owner Interference and Quantum Meruit

There is no privity of contract between a subcontractor retained by the general contractor on the one hand and the owner on the other. *Koltermann v. Underream*, 563 S.W.2d 950, 955 n.1 (Tex.Civ.App.–San Antonio 1977, writ ref'd, n.r.e.). Even if the owner makes direct payments and gives instructions to a subcontractor, in and of itself, this action does not create a contract between the owner and subcontractor. *Miles v. Plumbing Service of Houston, Inc.*, 668 S.W.2d 509 (Tex.App.–Houston [14th Dist.] 1984, writ ref'd, n.r.e.). There are, however, examples where an overly active owner can be found to have neither interfered with the job or have some responsibility for payment.

For example, the owner who repeatedly injects itself into issues between a contractor and subcontractor by adjusting claims, refusing to approve compliant work, increasing costs and delaying the project can be sued for unlawful interference inducing breach or termination of the subcontract. *American Surety Co. of New York v. Shaw*, 69 S.W.2d 47, 51-52 (Tex.Comm'n.App.–1934, holding approved); *Houston Auth. of City of Dallas v. Hubbell*, 325 S.W.2d 880, 898 (Tex.Civ.App.–Dallas 1959, writ ref'd, n.r.e.). By the same token, the owner who insists on performance in excess of contract specifications can be held liable for interference under a theory of duress. *Hubbell*, 325 S.W.2d at 900-906 (insisting on two coats of paint rather than the specified one coat). It has also been held in unique circumstances that the general contractor was merely an agent of the owner rendering both jointly and severally liable for the subcontractor's damages. *Grace Community Church v. Gonzales*, 853 S.W.2d 678 (Tex.App.–Houston [14th Dist.] 1993, no writ). Finally, there is the infrequent but possible circumstance where the owner could be held liable to the subcontractor for quantum meruit. *Rheiner v. Varner*, 627 S.W.2d 459, 463 (Tex.App.–Tyler 1981, no writ).

All of these problems involving owners may seem tangential to an evaluation of whether to terminate a subcontractor. However, all of these litigation situations necessarily involve the general contractor because the subcontractor will always sue both the owner and the general when asserting these claims. When an overly active owner constantly harps about the alleged nonperformance of a subcontractor, the general contractor should think twice about terminating the subcontractor simply because it is what the owner desires. All of the circumstances need to be evaluated. Again, proper documentation is imperative. If the subcontractor abandons the job before termination, the general contractor has a better chance of placing blame where it should lie. If the subcontractor is not performing and should be terminated, the general contractor should document all aspects of the situation so that the focus of the case is not on owner interference and the general contractor's subservient inactivity.

VI. CONCLUSION

As stated at the outset, the decision to terminate a subcontractor is one of the most difficult problems encountered by a diligent and conscientious general contractor. Documentation is critical. In even the most clear-cut case, the general contractor will still find itself embroiled in litigation. In the closer case, documentation may save the day. Finally, the decision to terminate a subcontractor should never been taken lightly or simply to placate the owner. There are a number of legal and practical pitfalls existing by virtue of the contract, Texas law or simply the facts and circumstances giving rise to the problem. All of these must be considered in order to avoid “a fall on the buttocks, a humiliating mishap or blunder” — the pratfall.