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Toward a Unified Theory of Damages in Construction Cases: Part III — Damages in Terminations for Convenience

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I. Introduction

This is the third installment in a series of articles aimed at bringing some clarity to the disparate approaches to damages practitioners often confront in construction cases.[1] Some of the most challenging damages questions are presented in termination disputes. The subject of damages in terminations is simply too complex for one article of this size, and therefore the damages series will address termination damages in three installments. This installment addresses damages in termination for convenience situations. Later installments will address damages in termination for default situations and special damages issues when design contracts are terminated.

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[1]See Josh M. Leavitt and Daniel G. Rosenberg, *Toward a Unified Theory of Damages in Construction Cases: Part I—Navigating Through the Diminution of Value v. Cost of Repair Debate in Defect Cases and Allocating Burdens of Proof*, 2 No. 1 Journal of the American College of Construction Lawyers, 1–51; Josh M. Leavitt & Daniel G. Rosenberg, *Toward a Unified Theory of Damages in Construction Cases, Part II — The Search for Unifying Theories in Common Law and Statutory Approaches to Treatment of Prejudgment and Post-Judgment Interest Awards on Prevailing Construction Damages Claims*, 2 No. 2 Journal of the American College of Construction Lawyers, 1–62.

There are several excellent secondary resources regarding the law of termination for convenience generally.[2] Unlike those resources, however, this article not only focuses on damages, but also organizes its analysis according to a) the categories of damages potentially available under a termination for convenience clause ("T for C clause") and b) the related parts of the T for C Clause and how they are drafted. T for C clauses often address the following types of recoveries: 1) lost profits on work not performed, 2) lost profits on work performed, 3) overhead, and 4) costs of the work. Provisions relating to profits often differentiate between profit on work performed prior to the termination versus profit on work not performed. Provisions relating to costs often differentiate between costs of the work, termination/settlement costs, and/or other specific types of costs.

Consider the following scenarios in which these various categories of damages may be implicated by the language within a T for C clause:

Variation 1: Private owner armed with a great new process design contracts with General Contractor ("GC") to build to a process plant for $200,000,000 over one year with 10% retainage to be paid upon successful passing of performance test. GC expects to make $15,000,000 in profit based on its historical profit percentage and productivity on process plant jobs. Owner terminates contractor for convenience before work starts when the license to use the process design falls through. The prime contract's T for C clause allows for recovery of lost profits. GC invested about $250,000 of time in learning the new process and purchasing special equipment. Also, in order to land this project, contractor had to commit certain key personnel and thus gave up opportunity for a project that was smaller but was also right in GC's sweet spot and more certain to generate a profit (roughly estimated at $5,000,000).

Variation 2: Owner encounters financing problems that force it to terminate for convenience after 10% of the work is complete. GC is feeling kind of lucky because a) rather than experiencing

[2]Among them are Michael T. Callahan, Termination of Construction and Design Contracts chs. 3, 6, 7 (2011); Philip L. Bruner & Patrick J. O'Connor, Jr., Bruner and O'Connor on Construction Law (2002); John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts ch. 11 (4th ed. 2006). These sources also cover termination damages as do several resources focused solely on damages. *See, e.g.,* Damages and Amount of Recovery Awardable to Government Contractor Upon Termination of Contract for Convenience, 12 A.L.R. Fed. 2d 551; William Schwartzkopf & John J. McNamara, Calculating Construction Damages (2d ed. 2000).

expected learning curve efficiencies, it began to suspect it blew its estimate when out of the box its productivity wasn't so good and GC was about to beef up its on-site supervision, b) one of its superintendants encountered a significant unforeseen condition, and c) one of the subcontractors, for reasons unrelated to the job, was about to default financially.

Variation 3: After the GC struggles to 20% completion, Owner terminates GC because GC's productivity problems were causing material delays, and GC persistently and repeatedly missed milestone dates. The Owner suspects some of the work might be defective, but does not want a big litigation expense and figures it can try to recover any repair costs later. Owner therefore does not identify in its termination notice whether the termination was for convenience or for default. By some miracle, Owner gets Subcontractor with a much smaller profit margin and overhead cost structure to take over from GC. Subcontractor completes the project on time for only 10% more than the contract amount remaining to be paid on the original base contract at the time of the termination. Contract is silent on method of calculating termination damages. GC files suit and argues bad faith termination because Owner simply found another contractor with a lower profit margin and deprived GC of the opportunity to improve its performance and achieve its expected profit.

The scenarios are meant to emphasize several key points.

Variation 1 illustrates that if a project terminated for convenience was never started, or barely started, expectation damages could yield a windfall to a GC. But, a GC might try to justify the recovery by arguing it reasonably relied on the contract award, gave up another job to get the project, and invested hard dollars in equipment and softer, but still real, dollars in learning curve. The GC in Variation 1 may have a strong track record for achieving profit percentage, but surely the Owner would argue there was no track record using the new process design and that no "measured miles" or other indications of productivity or profitability (at least on the project at issue) are possible if the project hadn't even started. The Owner might also argue that the specialty equipment could be sold or used by the GC on other jobs.

Variation 2 demonstrates that there may well be disagreements over the efficacy of the GC's project estimate and its productivity, and thus reason to believe the past profit levels would not have come to fruition in this instance. Variation 2 also presents problems of dealing with costs incurred on the job to date. How should the contractor be properly paid for work performed,

including profit and overhead on work performed? How should profit and overhead on the part of the work not performed be calculated? Is profit on work performed on a project a valid predictor of profit on work not performed when learning curves, conditions, and project planning might well have changes significantly later in the project?

Variation 3 illustrates that owners considering terminations have tactical choices to make relating to damages. A termination for default might present a higher damages award, but be difficult and expensive to achieve. Sometimes the path of least resistance is to terminate the contractor for convenience and be done with it. May an owner recapture costs for defective work if the owner terminates the contractor for convenience, effectively depriving the contractor of an opportunity to cure nonconformances (or achieve estimated productivity levels)? Does the termination clause adequately anticipate the damages alternatives that might present themselves and present either party with practical alternatives and protections?

Readers should keep these Variations in mind as we turn to the law.

II. A Brief Word on the Exceptions to the Enforceability of Termination for Convenience Clauses and the Types of Damages When Terminations are Deemed Wrongful

Termination for convenience is generally not an implied contractual right and must be specifically negotiated. Failure to do so, depending on the circumstances and jurisdiction, could subject the terminating party to a variety of breach of contract and wrongful termination claims and a panoply of damages.[3] Thus, one of the primary purposes of the T for C clause is to eliminate or reduce the risk of the imposition of exemplary damages, consequential damages, and a variety of other types of damages theories for bad faith or wrongful termination.

Generally, courts have upheld the enforceability of T for C clauses and their limitations on damages recoverable in termination for convenience scenarios.[4] Judicial enforcement of T for C clauses has its roots in federal contracting law and the strong public policy interests of permitting the government to cancel

[3] *See, e.g.,* Bruner & O'Connor, at § 18:47 and § 19:7.

[4] There are several sources that thoroughly discuss the history of T for C clauses; *See*, *e.g.*, Bruner & O'Connor, at § 18:47

certain types of contracts, for example wartime contracts.[5] Over the years, though, the enforceability of T for C clauses has extended to state and local government situations.[6] While the public policy justifications in private commercial contract settings may be less apparent, T for C clauses have been enforced there as well.[7] The so-called "standard form agreements," including those of the American Institute of Architect ("AIA"), Engineers Joint Contract Documents Committee ("EJCDC"), and "ConsensusDOCS" (endorsed by the Associated General Contractors of America and a number of other organizations), all contain T for C clauses.

Courts also may enforce contract provisions that provide for converting a wrongful termination into a termination for convenience, an option that might have helped in Variation 3 above.[8] Under the federal approach, for example, an improper termination for default can be converted to a termination for convenience, thus limiting the contractor to allowable termination-for-convenience damages even though the termination may otherwise

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[5] *See, e.g.*, Bruner & O'Connor, at § 18:45.50 (traces development of federal and state law doctrine of "constructive terminations for convenience," which allows terminations to be justified on a *post hoc* basis); John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts ch. 11, 1049 (4th ed. 2006); *see also* Jason Richey, The Termination for Convenience Clause: A Powerful Weapon in Contractual Disputes, K & L Gates Construction Law Blog (Dec. 1, 2007), http://www.klconstructionlawblog.com/2007/12/articles/articles-and-publications/the-termination-for-convenience-clause-a-powerful-weapon-in-contractual-disputes/.

[6] Michael T. Callahan, Termination of Construction and Design Contracts § 3.02 (2011). Recent case law examples include: 4N Intern., Inc. v. Metropolitan Transit Authority, 56 S.W.3d 860 (Tex. App. Houston 1st Dist. 2001) (court declines both parties' invitation to follow federal approach to exception to enforceability and holds under Texas law unambiguous termination for convenience clause terminable at will by government transit authority); *see also* Linan-Faye Const. Co., Inc. v. Housing Authority of City of Camden, 49 F.3d 915 (3d Cir. 1995).

[7] Recent examples include: Gulf Liquids New River Project, LLC v. Gulsby Engineering, Inc., 356 S.W.3d 54 (Tex. App. Houston 1st Dist. 2011), reh'g overruled, (Nov. 10, 2011) and rule 53.7(f) motion granted, (Dec. 21, 2011); DJB Bldg. & Const., LLC v. Parkville Plaza, LLC, 2009 WL 3644879 (Conn. Super. Ct. 2009); EDO Corp. v. Beech Aircraft Corp., 911 F.2d 1447 (10th Cir. 1990); Questar Builders, Inc. v. CB Flooring, LLC, 410 Md. 241, 978 A.2d 651 (2009).

[8] *See* Bruce W. Ficken & Sayward Mazur, The Termination of Contracts for Construction, Practicing Law Institute (2005).

be deemed wrongful.[9] Several courts have upheld conversion clauses attempting to achieve similar results in local government or private contracting settings.[10]

Having said that though, there have been occasions in relatively extreme situations in which courts have ruled that termination for convenience clauses and conversion clauses are unenforceable due to lack of mutuality, bad faith or some other malfeasance.[11] At the federal contracting level, in a series of widely cited cases, the Court of Claims and Federal Circuit have debated the applicable test for a review of a termination for convenience.[12] States sometimes do and sometimes do not follow the federal approach.[13]

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[9]John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts ch. 11, 1073 (4th ed. 2006). A recent example is: White Buffalo Const., Inc. v. U.S., 101 Fed. Cl. 1 (2011) (upholds conversion to termination for convenience when plaintiff failed to prove bad faith).

[10]John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts ch. 11, 1073 (4th ed. 2006). Recent examples include: *See, e.g.,* Gulf Liquids New River Project, LLC v. Gulsby Engineering, Inc., 356 S.W.3d 54 (Tex. App. Houston 1st Dist. 2011), reh'g overruled, (Nov. 10, 2011) and rule 53.7(f) motion granted, (Dec. 21, 2011) (in dispute involving EPC contracts to build a cryogenic plant to cool and liquefy off-gas from a refinery and a fractionator to process the off-gas from the cryogenic plant, appellate court reverses multi-million dollar jury verdict and upholds clause that provides that if owner wrongfully terminated contractor for cause, the termination shall be deemed a termination without cause and limits terminations damages to payment for work completed plus overhead and profit amount specified in the termination for convenience, but does allow recovery for pre-termination extra work); Quality Flooring v. B.F. Const. Co., Inc., 56 So. 3d 395, 402 (La. Ct. App. 4th Cir. 2011) (upholds trial award of 35% of value of subcontract work completed and declines to award "general" damages for wrongful termination where contract provided recovery of "amount due" under subcontract was "sole and exclusive remedy even where subcontractor was not properly terminated for default," and clause expressly provided that subcontractor would not be entitled to "special, consequential, exemplary damages" "nor to anticipate a profit" on account of termination); *cf.* Public Bldg. Authority of City of Huntsville v. St. Paul Fire and Marine Ins. Co., 80 So. 3d 171 (Ala. 2010) (in a reverse conversion situation, holds public building authority's termination of contractor for convenience may not be converted to termination for cause where contract did not so expressly state).

[11]*See, e.g.,* Philip L. Bruner & Patrick J. O'Connor, Jr., Bruner and O'Connor on Construction Law § 18:47 (2002); Ficken & Mazur, at 264.

[12]Bruner & O'Connor, at § 18:47; Ficken & Mazur, at 266; *see, e.g*, Torncello v. U. S., 231 Ct. Cl. 20, 681 F.2d 756, 771, 30 Cont. Cas. Fed. (CCH) P 70005 (1982) ("[W[e restrict the availability of the clause to situations where the circumstances of the bargain or the expectations of the parties have changed sufficiently that the clause serves only to allocate risk"); Municipal Leasing Corp.

In any event, these exceptions to the enforceability of T for C clauses are often limited and difficult to prove.[14] While the nuances of those cases are beyond the scope of this article, there are a number of excellent articles explaining the policies, history, and trends regarding the enforceability of T for C clauses.[15]

Breach of contract damages are the realm of T for C Disputes, and even then those damages are typically limited by the negotiated language of those clauses. Therefore, this article does not cover either punitive, exemplary, or consequential damages theories that surface in wrongful termination disputes or differing approaches to breach of contract damages commonly asserted in those situations. The recoverability and proof of damages for

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v. U.S., 7 Cl. Ct. 43, 32 Cont. Cas. Fed. (CCH) P 73129 (1984); Krygoski Const. Co., Inc. v. U.S., 94 F.3d 1537, 1540, 41 Cont. Cas. Fed. (CCH) P 76985 (Fed. Cir. 1996) ("An examination of termination for convenience law from several decades ago discloses mixed signals about limiting terminations under the bad faith/abuse of discretion standard in *Kalvar,* 543 F.2d at 1301–06, or the change of circumstances test in *Torncello,* 681 F.2d at 772. A full review of more recent case law, coupled with recent enactments, however, discloses a clear signal for implementation of termination for convenience clauses"); *see also,* Red River Holdings, LLC v. U.S., 802 F. Supp. 2d 648 (D. Md. 2011) (Lack of mutuality).

[13] *See, e.g.,* Ry-Tan Const., Inc. v. Washington Elementary School Dist. No. 6, 208 Ariz. 379, 93 P.3d 1095, 190 Ed. Law Rep. 564 (Ct. App. Div. 1 2004), opinion vacated on other grounds, 210 Ariz. 419, 111 P.3d 1019, 198 Ed. Law Rep. 327 (2005); (upholds ruling as a matter of Arizona law that constructive termination for convenience doctrine does not apply; distinguishes case law and federal policies from state law policies, and denies school district cross summary judgment motion when termination for convenience was first asserted two years after litigation began, where low bidder rule was involved and where there was no evidence of changed circumstances justifying their termination) *see also* Red River Holdings, LLC v. U.S., 802 F. Supp. 2d 648 (D. Md. 2011), and White Buffalo Const., Inc. v. U.S., 101 Fed. Cl. 1 (2011), EDO Corp. v. Beech Aircraft Corp., 911 F.2d 1447 (10th Cir. 1990); Questar Builders, Inc. v. CB Flooring, LLC, 410 Md. 241, 978 A.2d 651 (2009).

[14] *See, e.g,* District of Columbia v. Organization for Environmental Growth, Inc., 700 A.2d 185 (D.C. 1997) (reviews federal law of bad faith and changed circumstances cases and reverses Board's award of common law damages).

[15] *See, e.g.*, Bruner & O'Connor, at § 18:45.50 (traces development of federal and state law doctrine of "constructive terminations for convenience," which allows terminations to be justified on a *post hoc* basis); Jason Richey, The Termination for Convenience Clause: A Powerful Weapon in Contractual Disputes, K & L Gates Construction Law Blog (Dec. 1, 2007), http://www.klconstructionlawblog.com/2007/12/articles/articles-and-publications/the-termination-for-convenience-clause-a-powerful-weapon-in-contractual-disputes; William D. Lyman, To Pay or Not to Pay – To Stay or Not to Stay – Contractor's and Subcontractor's Right to Receive Payment for Work Performed and the Contractual and Legal Obstacles to Receiving It, American Bar Association Forum on the Construction Industry, October 2006.

wrongful termination will be covered in a later installment of this series. This article also does not cover prejudgment interest or other statutory remedies, which were covered more generally in a previous installment in the series.[16] Rather, this article considers damages that are available under enforceable and negotiated T for C clauses.

III. General Types of Damages Recoverable in Termination for Convenience Situations

Because the remedy for T for C is a creature of contract, the starting point for available damages is the common law damages available when one party is prevented from performing by the other party. In the context of an owner termination, and putting aside tort damages, interest, and attorneys' fees, and depending on a variety of factors, the contractor will usually have available to it some form of expectation, reliance or restitution damages. The critical feature in an expectation damages recovery, after adjustment to the contract prices for amounts and costs of the work performed, is an analysis of the anticipated profit (or loss) on the uncompleted work. In a reliance-based approach, which might be preferred by an aggrieved contractor when anticipated profits may be difficult to prove or may be inadequate, the focus is on direct and indirect costs incurred. In a *quantum meruit* based approach, which might apply in a quasi-contract situation, the focus is on the reasonable value of services rendered. An excellent discussion of the theoretical differences between these approaches and their formulas appears in Section 19:71 of Bruner and O'Connor's *Bruner and O'Connor on Construction Law*.[17] That theoretical discussion is not practical here, though, because invariably the termination for convenience clause intentionally (or unintentionally) sets the approach to damages and usually limits what can be recovered.

The most common expressly-contractual formula for recovery of payments or damages in T for C situations is some combination of lost profits and costs of work performed. There are a variety of approaches to negotiating these combinations even in what are often described as the "standard" form industry agreements and various federal and state regulations. When it comes to T for C

[16] Josh M. Leavitt & Daniel G. Rosenberg, *Toward a Unified Theory of Damages in Construction Cases, Part II — The Search for Unifying Theories in Common Law and Statutory Approaches to Treatment of Prejudgment and Post-Judgment Interest Awards on Prevailing Construction Damages Claims*, 2 No. 2 Journal of the American College of Construction Lawyers, 1–62.

[17] Bruner & O'Connor, at § 19:71.

clauses, however, the "standard forms" are not so standard. Some comparisons are in order:

The AIA A201 (2007) General Conditions of the Contract for Construction (the "AIA A201") expressly allows for the recovery of payments for the work performed as well as reasonable overhead and profit on work not performed. Section § 14.4.3 of the A201 (part of section 14.4, titled "Termination By the Owner For Convenience") provides:

> In case of such termination for the Owner's convenience, the Contractor shall be entitled to receive payment for Work executed, and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed.

The AIA added the clause in 1997.[18]

The ConsensusDOCS 200: Owner/Contractor Standard Agreement & General Conditions (Lump Sum) ("ConsensusDOCS 200"), issued in 2007, requires payment for the work performed to date, including overhead and profit but does not provide for recovery of profit on work not performed. Instead, a blank for a fee premium is left for the parties to complete if they so choose. Section 11.4.2 ("Termination By Owner for Convenience") states:

> 11.4.2 If the Owner terminates this Agreement for Convenience, the Constructor shall be paid:
>
> (a) for the Work performed to date including Overhead and profit;
>
> (b) for all demobilization costs and costs incurred as a result of the termination but not including Overhead or profit on Work not performed; and
>
> (c) a premium set forth in a schedule below.

Section 11.4.3 then specifies mitigation efforts required by the contractor relating to subcontracts, materials, supplies and equipment.

The EJCDC C-700 Standard General Conditions of the Construction Contract (2007) requires payment for completed work including "fair and reasonable" sums for overhead and profit, expenses for uncompleted work, plus "fair and reasonable" sums for overhead and profit, plus costs for settlement of subcontracts, reasonable termination expenses but not "loss of anticipated

[18] The AIA similarly permits an architect that has been terminated for convenience to recover "for services performed prior to termination, together with Reimbursable Expenses then due and all Termination Expenses." AIA § 9.6. Termination Expenses are defined as "expenses directly attributable to termination for which the Architect is not otherwise compensated, plus an amount for the Architect's anticipated profit on the value of the services not performed by the Architect." AIA § 9.7

profits." Section 15.03 (*"Owner May Terminate For Convenience")* provides:

A. Upon seven days written notice to Contractor and Engineer, Owner may, without cause and without prejudice to any other right or remedy of Owner, terminate the Contract. In such case, Contractor shall be paid for (without duplication of any items):

1. completed and acceptable Work executed in accordance with the Contract Documents prior to the effective date of termination, including fair and reasonable sums for overhead and profit on such Work;

2. expenses sustained prior to the effective date of termination in performing services and furnishing labor, materials, or equipment as required by the Contract Documents in connection with uncompleted Work, plus fair and reasonable sums for overhead and profit on such expenses;

3. all claims, costs, losses, and damages (including but not limited to all fees and charges of engineers, architects, attorneys, and other professionals and all court or arbitration or other dispute resolution costs) incurred in settlement of terminated contracts with Subcontractors, Suppliers, and others; and

4. reasonable expenses directly attributable to termination.

B. Contractor shall not be paid on account of loss of anticipated profits or revenue or other economic loss arising out of or resulting from such termination.

In federal contracts, the costs recoverable for a T for C are governed by extensive Federal Acquisition Regulations (the "FAR"). It is said that the FAR gives the government a broad right to terminate for the convenience of the government, without cause, but guarantees the contractor entitlement to certain payments, although the contractor's recovery is limited to costs incurred, profit on work done and the cost of preparing the settlement proposal.[19]

There are many iterations of T for C clauses in the FAR for different types of situations, but "Alternate I "of Section 52.249-2 ("Termination for Convenience of the Government (Fixed-Price)") governs when contracts are for construction. The Contracting Officer is permitted to terminate for convenience when he or she "determines a termination is in the Government's interest."[20] The contractor and the Contracting Officer may agree on an amount to be paid including a "reasonable allowance for profit on work done" (subject to some limitations), but if they fail to agree, subsection (g) of the regulation kicks in, which provides that the

[19] Pacificorp Capital, Inc. v. U.S., 25 Cl. Ct. 707, 37 Cont. Cas. Fed. (CCH) P 76292, 1992 WL 68805 (1992), aff'd, 988 F.2d 130 (Fed. Cir. 1993).

[20] FAR 52.249(a).

Contracting Officer shall pay the following in a construction context:

> (g) If the Contractor and Contracting Officer fail to agree on the whole amount to be paid the Contractor because of the termination of work, the Contracting Officer shall pay the Contractor the amounts determined as follows, but without duplication of any amounts agreed upon under paragraph (f) of this clause:
>
> (1) For contract work performed before the effective date of termination, the total (without duplication of any items) of—
>
> (i) The cost of this work;
>
> (ii) The cost of settling and paying termination settlement proposals under terminated subcontracts that are properly chargeable to the terminated portion of the contract if not included in subdivision (g)(1)(i) of this clause; and
>
> (iii) A sum, as profit on subdivision (g)(1)(i) of this clause, determined by the Contracting Officer under 49.202 of the Federal Acquisition Regulation, in effect on the date of this contract, to be fair and reasonable; however, if it appears that the Contractor would have sustained a loss on the entire contract had it been completed, the Contracting Officer shall allow no profit under this subdivision (g)(1)(iii) and shall reduce the settlement to reflect the indicated rate of loss.
>
> (2) The reasonable costs of settlement of the work terminated, including—
>
> (i) Accounting, legal, clerical, and other expenses reasonably necessary for the preparation of termination settlement proposals and supporting data;
>
> (ii) The termination and settlement of subcontracts (excluding the amounts of such settlements); and
>
> (iii) Storage, transportation, and other costs incurred, reasonably necessary for the preservation, protection, or disposition of the termination inventory.

Interestingly, there are termination for convenience provisions in the "FIDIC" standard forms of Conditions of Contract for:

- Construction for Building and Engineering Works Designed by the Employer (1st ed. 1999) (the "Red Book");
- Plant and Design-Build for Electrical and Mechanical Plant, and for Building and Engineering Works, Designed by the Contractor (1st ed. 1999) (the "Yellow Book");
- EPC/Turnkey Projects (1st ed. 1999) (the "Silver Book");

which are widely used in international projects. The "FIDIC" suite of construction contracts is published by the International Federation of Consulting Engineers. The FIDIC acronym stands for the French version of the Federation's name (Federation Internationaledes Ingenieurs-Conseil).

The provisions are identical in each of these particular FIDIC forms. The owner (the "Employer") is entitled to terminate for

convenience (although the forms include a proviso that the Employer cannot then perform the work itself or to arrange for another contractor to perform the work.) The basic trade-off is that the Contractor is entitled to be paid for the work for which a price is stated in the contract, for certain other specified costs and for costs reasonably incurred, but not profit. Sub-clause 15.5 ("Employer's Entitlement to Termination") provides:

> The Employer shall be entitled to terminate the Contract, at any time for the Termination Employer's convenience, by giving notice of such termination to the Contractor. The termination shall take effect 28 days after the later of the dates on which the Contractor receives this notice or the Employer returns the Performance Security. The Employer shall not terminate the Contract under this Sub-Clause in order to execute the Works himself or to arrange for the Works to be executed by another contractor. After this termination, the Contractor shall proceed in accordance with Sub-Clause 16.3 *[Cessation of Work and Removal of Contractor's Equipment]* and shall be paid in accordance with Sub-Clause 19.6 *[Optional Termination, Payment and Release].*

Sub-clause 19.6 ("Optional Termination, Payment and Release") provides:

> If the execution of substantially all the Works in progress is prevented for a continuous period of 84 days by reason of Force Majeure of which notice has been given under Sub-Clause 19.2 *[Notice of Force Majeure],* or for multiple periods which total more than 140 days due to the same notified Force Majeure, then either Party may give to the other Party a notice of termination of the Contract. In this event, the termination shall take effect 7 days after the notice is given, and the Contractor shall proceed in accordance with Sub-Clause 16.3 *[Cessation of Work and Removal of Contractor's Equipment].*
>
> Upon such termination, the Employer shall pay to the Contractor: (a) the amounts payable for any work carried out for which a price is stated in the Contract; (b) the Cost of Plant and Materials ordered for the Works which have been delivered to the Contractor, or of which the Contractor is liable to accept delivery: this Plant and Materials shall become the property of (and be at the risk of) the Employer when paid for by the Employer, and the Contractor shall o place the same at the Employer's disposal; (c) any other Cost or liability which in the circumstances was reasonably incurred by the Contractor in the expectation of completing the Works; (d) the Cost of removal of Temporary Works and Contractor's Equipment from the Site and the return of these items to the Contractor's works in his country (or to any other destination at no greater cost); and (e) the Cost of repatriation of the Contractor's staff and labour employed wholly in connection with the Works at the date of termination.

"Cost" is defined by Sub-clause 1.1.4.2 as "all expenditure rea-

sonably incurred (or to be incurred) by the Contractor, whether on or off the Site, including overhead and similar charges, but does not include profit."

Obviously, there are many other possible approaches, but the clauses above (and often privately-negotiated clauses) have in common that they address in one form or another lost profits (both on work not performed and work actually performed), overhead, and costs or value of the work performed. The subsections that follow address each of these major categories of T for C damages.

III. Categories of Damages

A. Lost Profits

1. Lost Profits Generally

The starting point for an analysis of the drafting and negotiation of clauses addressing the recoverability of lost profits is an understanding of the nature of lost profits in a construction project and how to prove them. Clause drafters might want to understand the rules for recoverability of lost profits when a clause is silent or does not limit or exclude them.

Black letter law provides that lost profits generally will not be awarded if deemed speculative.[21] Entire treatises are written on the recoverability and proof of lost profits.[22]

Proving lost profits in a construction context has its particular challenges because of the prevalence of unforeseen conditions, changed circumstances, varying durations, complexity, uniqueness and the multi-party nature of many construction projects. In situations (such as Variation 1 above) when a contract is terminated for convenience where no or little work was performed, there not only may be no or little evidence of actual productivity levels achieved on the project at issue, but there also may be no similar prior project for comparison. The available proof may be limited to the reasonableness of the budget, schedule and estimate and the similarity of the project to past projects. Sensitive and even proprietary company information may need to be used to prove lost profits. In situations (such as Variation 2 above) where the project was terminated midstream there may be some evidence of the ability of the contractor to perform the work profitably, but the complex part of the project might not yet have been performed, or some unforeseen conditions might not yet

[21] *See* Robert L. Dunn, Recovery of Damages for Lost Profits (6th ed. 2005).

[22] *See, e.g.,* Dunn.

have been encountered, or learning curve efficiencies might not yet have been achieved.

One case that discusses in a fair amount of detail the proof required to prove lost profits in a construction context is *Tull v. Grundersons, Inc*.[23] In that case a contractor sought a lost profits recovery when a contract to build a golf course was breached when the owner was unable to obtain financing to complete the project. We are not told what percent the project was complete at the time of the breach. The word "termination" does not appear in the opinion and no termination clause language is even discussed. Nevertheless, the opinion is instructive.

The trial court entered judgment only for unpaid retainage and interest and denied recovery of all lost profits damages and certain other damages items (including costs of leasing equipment and "mitigation damages" such as the costs of bidding work on replacement projects that it claimed it could not otherwise have bid). The appeals court reversed and directed an award of all three categories of damages. The Colorado Supreme Court then affirmed in part and reversed in part and provided an unusually substantial analysis of the relative burdens of proof and the evidence regarding lost profits.

Applying an expectation damages type approach, the court explained that the formula for proving lost profits in a construction case starts with the contract price, then subtracts payments made, and then further subtracts what it would have cost had the builder completed the project in accordance with the contract. The contractor was required to establish the fact of damages with "reasonable certainty," not necessarily with "mathematical certainty," but also not with mere "speculation."[24] The court referred to a "threshold burden" to lay out the fact of lost profits damages. The court held that an itemized estimate of costs to complete presented by the builder's witnesses was "fair and reasonable" and met that initial burden even though there were disputes at trial about certain of the items.[25] (The court suggested that a mere lump sum estimate would not have met the builder's initial burden.)

The *Tull* court held that the lower court improperly excluded evidence of the contractor's past profit experience on other projects and on the project itself. The court noted that such evidence is "widely accepted" as relevant in lost profits cases. The court

[23]Tull v. Gundersons, Inc., 709 P.2d 940, 52 A.L.R.4th 699 (Colo. 1985).

[24]*Tull*, 709 P.2d at 943.

[25]*Tull*, 709 P.2d at 945.

cautioned (citing a treatise) that the admissibility of evidence of past profits is governed by the rule that "prior and subsequent experience must be comparable."[26] It concluded that the excluded evidence was "sufficiently comparable" and that any dissimilarities may be considered by the trier of fact in evaluating the weight of the evidence. (Disappointingly, no specifics regarding that evidence appear in the opinion.) The court also observed (again citing a treatise) that evidence of profitability on the project itself is "invariably held admissible" as the "simplest and most obvious method of calculating lost profits is a computation based upon the contract . . . which has been invaded by the defendants' claimed wrongful conduct."[27]

The case *Indiana & Michigan Elec. Co. v. Terre Haute Industries, Inc.*, further illustrates the challenge of proving future profits.[28] Although *Indiana & Michigan Elec. Co.* is not a termination for convenience case, the court undertook an unusually in-depth review of the lost profits evidence. In *Indiana & Michigan Elec. Co.,* the owner hired the contractor to perform part of an installation of an electrostatic precipitator (an apparatus calculated to control air pollution created by coal-fired generators). After an alleged failure to meet the completion dates in the contract, the owner terminated the contract, and the contractor brought a suit claiming damages for, among other things, lost future profits based on reputation damage. The contractor brought in an expert to calculate the amount of lost future profit due to reputation damage by analyzing the contractor's bid history and determining the contractor's percentage of successful bids. The expert did a linear regression mathematical analysis to compare the contractor's post-termination business to its pre-termination business, and his findings showed that after the termination, although the contractor's percentage of successful bids remained constant, the total number of bids decreased sharply. The expert attempted to correct for recession and other general business conditions using 22 different economic indicators to determine the appropriate adjustments. The expert then conservatively calculated the subcontractor's profit at 10% of the estimated revenue (despite the subcontractor making 14% and 15% profit in some years), and determined that the contractor had lost nearly $3 million in profit. The court noted, however, that the contractor

[26] *Tull*, 709 P.2d at 945.

[27] *Tull*, 709 P.2d at 945.

[28] Indiana & Michigan Elec. Co. v. Terre Haute Industries, Inc., 507 N.E.2d 588, 605–607 (Ind. Ct. App. 1987).

presented "no evidence whatever of any specific job that it failed to get that is attributable to the breach of contract or any other specified reason."[29] The court ultimately held in relevant part that future profits due to reputation damage are not recoverable in a breach of contract action, but also found the subcontractor's expert's evidence to be "wholly conjectural," suggesting that even if recovery were permitted under the law, the evidence here was not sufficient.[30]

Tull and *Indiana & Michigan Elec. Co.* are significant because they provide thoughtful analysis in a hard-to-find reported situations regarding the relative burdens for proving lost profits in the absence of a negotiated T for C clause that limits lost profits. Unfortunately, there is little discussion in the opinions regarding differences that might exist in proving lost profits on work performed versus lost profits on work not performed. Those differences are important because, as discussed in the next subsections, many T for C clauses distinguish between those types of lost profits damages.

2. Lost Profits on Work Not Performed

One of the most commonly negotiated components of a T for C clause is entitlement to lost profits on work not performed. Owners tend to view such damages as speculative and difficult to prove and thus a potential windfall to a contractor. On the other hand, contractors faced with the prospect of opportunity costs or significant investments to obtain work might look to lost profits as part of the *quid pro quo* for agreeing to a contract with a T for C clause.

Owners often bargain in a T for C clause for an express exclusion of the recovery of any lost profits on work not performed. There are many ways to express the concept.[31] The "standard" forms all differ on approach. The EJCDC C-700 expressly states the contract "shall not be paid on account of loss of anticipated profits," whereas it expressly allows for "profit" on completed work.

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[29] *Indiana & Michigan Elec. Co.,* 507 N.E. 2d at 605–06.

[30] *Indiana & Michigan Elec. Co.,* 507 N.E. 2d at 607.

[31] *See, e.g.*, Quality Flooring v. B.F. Const. Co., Inc., 56 So. 3d 395, 402 (La. Ct. App. 4th Cir. 2011) (court contractor limited to payment for percentage of work performed where clause provided "Subcontractor shall, in no event, be entitled to special, consequential or exemplary damages nor to anticipate a profit on account of termination"); Praecomm, Inc. v. U.S., 78 Fed. Cl. 5 (2007), aff'd, 296 Fed. Appx. 929 (Fed. Cir. 2008); International Data Products Corp. v. U.S., 492 F.3d 1317 (Fed. Cir. 2007).

Interestingly, the Consensus Docs, which are often said to be among the more pro-contractor of the standard forms, actually does not provide for overhead and profit on the work not performed. Instead, ConsensusDOCS 200 gives the contracting parties the option to specify a "premium" in a blank left in Section 11.4.2(c).

Under, the federal approach, there is no express exclusion of lost profits on work not performed. However, the commentators and cases generally conclude that under the federal framework there is no recovery of such lost profits.[32]

By contrast, the AIA standard form contracts expressly allow for the recovery of reasonable overhead and profit on work not performed. Section § 14.4.3 of the AIA A201 provides: "In case of such termination for the Owner's convenience, the Contractor shall be entitled to receive payment for . . . overhead and profit on the Work not executed." Naturally, many owners cross out this aspect of the AIA language.

The AIA language offers no guidance regarding the amount of overhead and profit, and it does not excuse a contractor from meeting its burden of proof, as demonstrated by a recent case. In *Winmar, Inc. v. Al Jazeera International*, the court held that even with an AIA contract that expressly allowed "reasonable overhead and profit" on work not executed, and even though the court awarded a variety of damages to the plaintiff including profit on worked performed and overhead, the contractor had not met its burden to prove its lost profit on work not performed.[33] The dispute involved a contract to build a state of the art television studio and office for Al Jazeera in Washington D.C. The court had allowed recovery of a number of cost and even overhead

[32] *See e.g.*, John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts ch. 11 (4th ed. 2006); Pacificorp Capital, Inc. v. U.S., 25 Cl. Ct. 707, 37 Cont. Cas. Fed. (CCH) P 76292, 1992 WL 68805 (1992), aff'd, 988 F.2d 130 (Fed. Cir. 1993) (under the federal framework "Recovery of profits on work not performed is not recoverable."); Ry-Tan Const., Inc. v. Washington Elementary School Dist. No. 6, 208 Ariz. 379, 93 P.3d 1095, 190 Ed. Law Rep. 564 (Ct. App. Div. 1 2004), opinion vacated on other grounds, 210 Ariz. 419, 111 P.3d 1019, 198 Ed. Law Rep. 327 (2005) ("Recovery of anticipated profit is precluded"); William Schwartzkopf & John J. McNamara, Calculating Construction Damages 117 (2d ed. 2000) ("The general policy that has developed is against the recovery of profit on unperformed work" and "this policy in government contracts is very strong").

[33] Winmar, Inc. v. Al Jazeera Intern., 741 F. Supp. 2d 165, 195 (D.D.C. 2010), judgment amended on other grounds, 813 F. Supp. 2d 163, 80 Fed. R. Serv. 3d 1034 (D.D.C. 2011), vacated in part on other grounds, 831 F. Supp. 2d 159 (D.D.C. 2011).

items. The parties had agreed to a scheduled amount that showed an amount for "overhead and fee." Al Jazeera argued that the contractor failed to break out "overhead" from "fee" and that the term "profit" as used in the termination for convenience provision was not synonymous with "fee." The court seemed to emphasize Al Jazeera's argument that "fee is simply an amount charged, whereas lost profits are the difference between gross income and the costs or expenses that had to be expended to produce that income."[34] The court held that the contractor had not met its burden of proof. The court also observed that while it was not necessary to decide the issue, it may well be that the termination for convenience provision required the contractor to "prove to a reasonable certainty, the amount of profit it would have actually realized through performance of the Contract."[35]

Winmar also provides potential authority for the proposition that unless loss profits are expressly excluded, they may be recoverable if proven. Although the issue was not strictly presented to the Court in the context of loss profits on work not performed, as discussed in the next subsection herein, the Court held that lost profits on work performed were recoverable because *they* were not expressly excluded. Such a ruling in the context of profit on work not performed because not expressly excluded would be contrary, however, to the line of federal contracting cases (referenced above) holding that lost profits on work not performed are not recoverable.[36]

Certain issues with the recoverability and proof of loss profits are as equally applicable to loss profits on work performed as on work not performed and will be addressed in the next subsection.

3. Lost Profits on Work Performed

Another issue commonly negotiated in termination for convenience clauses is the extent to which the contractor may recover profits on work actually performed. Contractors argue that when the owner has the right to essentially terminate the contractor at will, and deprive the contractor of its full expectation damages (lost profits), the contractor should at least receive its reliance damages (such as certain pre-termination costs) and some measure of profit on the work performed, or, alternatively, a *quantum*

[34] *Winmar*, 741 F. Supp. 2d at 195.

[35] *Winmar*, 741 F. Supp. 2d at 195 n.37.

[36] *But see* Lamb Engineering & Const. Co. v. Nebraska Public Power Dist., 103 F.3d 1422, 1429 (8th Cir. 1997) (Under Nebraska law contractor could not be awarded damages for loss of expected gross margin in face of clause requiring payment of "reasonable and proper charges for termination").

meruit recovery or costs-plus-fee recovery.[37] Owners, on the other hand, will seek to avoid a contractor windfall and often negotiate for some type of exclusion or cap on lost profits or fee on work performed, or an offset to the recoverability of lost profits if the contractor was operating at a loss at the time of the termination. And, sometimes parties make a simple horse-trade where the contractor is not allowed profit on the portion of the work not performed but is allowed a definite amount of profit on the portion of the work actually performed.[38]

Termination for convenience clauses are often left ambiguous with respect to lost profits, sometimes intentionally so. However, clauses that are silent or vague as to how to calculate lost profits can lead to disputes in which counsel will be called upon to parse clauses by asking questions such as: What type of proof is allowed to be considered and who has the burden of proof? If the clause or the applicable law required "reasonable" profits, what are "reasonable" profits on work performed? Are lost profits included when the clause specifies payment for the "value" of the work or the "costs" of the work? What does payment for the "value" of the work mean as compared to simply "payment for the work" or for "the contract price for the work" or "the percentage of the work complete" or the "costs" of the work? Does "value" of the work mean some industry standard value or the value as negotiated in the contract price? What if we are dealing with a contract price that includes a substantial amount of profit and overhead compared with any industry norm? Are the answers to these questions impacted by whether the contract utilized a cost plus, fixed fee, target pricing or some other type of payment arrangement? Is unabsorbed overhead distinct from lost profit and is it recoverable?

Again, the so called "standard" contract forms reflect different approaches.

The AIA A201 provides that "the Contractor shall be entitled to receive payment for payment for Work executed." Interest-

[37]The availability of reliance or *quantum meruit* damages may depend on what legal theories are available in addition to (or instead of) breach of contract. Examples might be promissory estoppel, unjust enrichment or some tort or quasi-contract theory.

[38]For a rare example of a judicially imposed horse-trade, see McDonnell Douglas Corp. v. U.S., 37 Fed. Cl. 270, 274, 41 Cont. Cas. Fed. (CCH) P 77035 (1996) in which the court, for national security reasons, limited McDonnell Douglas' damages to incurred costs in the development of the "stealth" attack craft for Navy and removed from the case both the contractor's claim for loss profits and the government's loss ratio adjustment defense.

ingly, the AIA says nothing expressly about whether such "payment" includes profit even though, as we saw earlier, the A201 expressly provides for payment of "reasonable overhead and profit on the Work not executed." A contractor may argue, however, that inclusion of profit is implied in the phrase "payment for Work executed." An owner might counter that if the clause intended to imply payment of profit was included in payment for work performed then in would have expressly so stated or at a minimum called for payment of the contract price/amount for the percentage of work completed.

By contrast, the ConsensusDOCS 200, expressly provides for payment for "the Work performed to date, including overhead and profit."

The EJCDC C-700 provides for payment for "completed and acceptable Work executed in accordance with the Contract Documents prior to the effective date of termination, including fair and reasonable sums for overhead and profit on such Work." No guidance is provided concerning the meaning of "reasonableness." This leaves open the question, for example, whether the contractor who managed to include a high amount of profit and overhead in its prices is subject to a reduction if the owner can show the contractor was experiencing lower profitability on the project or that some notion of an industry standard profit rate was substantially less than the contractor's margin.

The federal approach is to allow recovery of costs plus "[a] sum, as profit . . . to be fair and reasonable," and the FAR provides a number of factors, discussed below concerning the determination of what is "reasonable."[39] Additionally, the FAR provides (in what is referred to as the "loss adjustment provision," that "if it appears that the Contractor would have sustained a loss on the entire contract had it been completed, the Contracting Officer shall allow no profit . . . and shall reduce the settlement to reflect the indicated rate of loss."[40] More than one case and commentator has stated that (subject to the application of the loss adjustment provision) the practical effect of a federal termination for convenience is to convert a fixed-cost contract into a cost-plus contract for the work performed prior to the termination.[41]

As previewed earlier, there is a risk that if an owner does not

[39]FAR 52.249-2, Alternate I(g)(1)(i)–(iii).

[40]FAR 52.249-2, Alternate I(g)(1)(iii).

[41]*See e.g,* District of Columbia v. Organization for Environmental Growth, Inc., 700 A.2d 185, 200 (D.C. 1997); Jason Richey, The Termination for Convenience Clause: A Powerful Weapon in Contractual Disputes, K & L Gates

expressly exclude or limit lost profits on work performed, a court may construe an intent to allow lost profits. In *Winmar*, the clause at issue was an AIA-type provision calling for the contractor to receive "payment for work executed and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed."[42] The court emphasized the absence of an exclusivity clause restricting the contractor's termination for convenience remedies exclusive of its common law remedies for breaches of contract, and the presence of a general clause providing both parties with remedies available at law. The court also vaguely noted the "equities" of the termination for convenience situation and a restitution-type approach. The court went on to calculate the amounts for the "value" of the work performed, interest, general conditions and other amounts. The court noted though that the there could be no "double recovery," it did not discuss why there would not be a double recovery if the court awarded amounts for "value."[43] As stated earlier, the reasoning in *Winmar* might be surprising to those who do not make it a practice of expressly excluding certain types of loss profits with certain types of T for C clauses.

There are a number of cases suggesting that T for C clauses allowing payment for work performed or for payment based on a percentage of completion of work performed may entitle a contractor terminated for convenience to payment not only for costs of the work performed but to some amount of lost profits. One court, in *Red River Holdings, LLC v. United States*,[44] held that regulations requiring a percentage of work performed payment entitles a contractor to "compensation for costs incurred *and* some amount of profit on those costs."

Construction Law Blog (Dec. 1, 2007), http://www.klconstructionlawblog.com/2007/12/articles/articles-and-publications/the-termination-for-convenience-clause-a-powerful-weapon-in-contractual-disputes/; White Buffalo Const., Inc. v. U.S., 52 Fed. Cl. 1, 4 (2002).

[42]Winmar, Inc. v. Al Jazeera Intern., 741 F. Supp. 2d 165, 177 (D.D.C. 2010), judgment amended on other grounds, 813 F. Supp. 2d 163, 80 Fed. R. Serv. 3d 1034 (D.D.C. 2011), vacated in part on other grounds, 831 F. Supp. 2d 159 (D.D.C. 2011).

[43]*Winmar*, 741 F. Supp. 2d at 180.

[44]Red River Holdings, LLC v. U.S., 802 F. Supp. 2d 648, 662 n.18 (D. Md. 2011).

Similarly, the court in *Arc Electrical Construction Co. v. George A. Fuller Co.*[45] interpreted a clause requiring payment of "the entire amount due" as requiring payment of lost profits.[46] The court would not work a "forfeiture" where failure to comply with provisions was hindered by the terminating party.

In *United States for the Benefit & Use of EPC Corp. v. Travelers Casualty & Surety Co. of America*,[47] the court, in an adversary proceeding involving the bankruptcy of a general contractor, construed a clause requiring a general contractor to "pay [the subcontractor] for that Work actually performed in an amount proportionate to the sum payable under [the] Agreement." (The clause also stated the general contractor would "not be liable for any other costs nor for prospective profits on Work not performed.") The subcontractor argued on a motion for summary judgment that it was entitled as a matter of Utah law to be paid its actual costs plus a reasonable overhead and profit. The court ruled that contract required the percentage of the work payment including profit. The court also denied a *quantum meruit* approach under the doctrine that a quasi-contract *quantum meruit* recovery is not available where a valid contract exists.

In *HAR Construction, Inc. v. San Diego Unified School District*[48] a California court construed a provision entitling the contractor to payment for "Work actually performed and in place" as of the effective date of the termination "with a reasonable allowance for overhead and profit on such Work." The clause also expressly allowed payment of termination expenses, retainage on work completed, and excluded profits and overhead on work not performed. The clause further provided that such payment (exclusive of termination expenses) "shall not exceed the total Contract Price as reduced by payments previously made . . . and 'the value of the Work not yet completed.' " The parties' estimates of completion at the time of the termination of the project, which was a high school project, were far apart (44% vs. 16-18%). The

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[45] Arc Elec. Const. Co. v. George A. Fuller Co., 24 N.Y.2d 99, 299 N.Y.S.2d 129, 247 N.E.2d 111 (1969).

[46] This is cited and discussed at length in Jason Richey, The Termination for Convenience Clause: A Powerful Weapon in Contractual Disputes, K & L Gates Construction Law Blog (Dec. 1, 2007), http://www.klconstructionlawblog.com/2007/12/articles/articles-and-publications/the-termination-for-convenience-clause-a-powerful-weapon-in-contractual-disputes/.

[47] U.S. for the Benefit & U.S. ex rel. EPC Corp. v. Travelers Cas. & Sur. Co. of America, 423 F. Supp. 2d 1016, 1025 (D. Ariz. 2006).

[48] HAR Const., Inc. v. San Diego Unified School Dist., 2006 WL 2766892 (Cal. App. 4th Dist. 2006), unpublished/noncitable.

contractor, which must have had a fair amount of profit built into its contract price, relied on a schedule of values approach. The school district argued for an approach based on documented costs incurred plus profit, which it tried to introduce through expert testimony. The court instructed the jury, however, that if the evidence showed that a certain schedule of values was approved, then damages must be based on the schedule of values and other proven damages. A verdict based on the schedule of values approach was upheld, but it is unclear from the appellate opinion if the cost approach would have been allowed if the expert testimony was more properly preserved and if the proof of the district's receipt of schedule of values (which was contested) had failed. The opinion illustrates the difference a schedule of values-based approach can make over a cost-based approach, but it is also unclear what the result would have been if the language of the clause had more clearly required a cost-based analysis.

Of course, an owner may be able to convince a court that the contractor would not have earned profit had the project not been terminated. As stated earlier, under the federal "loss adjustment" approach, if a contractor would have sustained a loss on the project had it been completed, no profit is awarded part of the T for C.[49]

At least one commentator has suggested that although there are no loss adjustment provisions in the AIA A201 and EJCDC C-700 termination for convenience clauses, the "common law measure of damages would require such an adjustment."[50]

At least one court has questioned whether, despite the harshness of the result, the loss adjustment should be applied not only to reduce lost profits but also recoverable costs. In *Abadie, III v. Organization for Environmental Growth, Inc.*,[51] the court reiterated a previous opinion in which it held that termination costs, and not just lost profits, might have to be reduced by a loss adjustment. While in theory the concept seems logical for the court to have discussed, the adjustment might not have been required by the contract documents at issue. The court stated that it was relying on "the plain language" of a manual contain-

[49]48 C.F.R. § 52.249-2(f)(2)(iii); *see* Philip L. Bruner & Patrick J. O'Connor, Jr., Bruner and O'Connor on Construction Law n.11 (2002); *see* Michael T. Callahan, Termination of Construction and Design Contracts chs. 3, 6, 7 (2011); *see* Charles G. Williams Const., Inc., ASBCA No. 49775 (2000).

[50]Bruner & O'Connor (citing Restatement Second of Contracts § 347(c)).

[51]Abadie v. Organization for Environmental Growth, Inc., 806 A.2d 1225, 1230 n.14 (D.C. 2002).

ing a loss adjustment provision. Curiously, however, the manual upon which the court relied seems to have actually stated "if it appears that the Contractor would have sustained a loss on the entire Contract had it been completed, no profit shall be included or allowed . . . and an appropriate adjustment shall be made reducing the amount of the settlement to reflect the indicated rate of loss." That court, however, appeared particularly frustrated with the claims and the litigation, which had gone on for years.

Under the federal framework, the burden is on the government to prove entitlement to a loss adjustment.[52] The ability to prove whether a project was sustaining or would have sustained a loss can be the subject of expensive and conflicting expert witness opinions about productivity and the causes of inefficiencies and consideration of un-priced changes and modifications. Issues that courts have dealt with include learning curves and the inequity of a contractor being prevented by the termination from improving its productivity.[53]

In *White Buffalo Construction, Inc. v. United States*,[54] the loss adjustment analysis of whether the project would in the end have been profitable wasn't discussed *per se*, but the court's consideration of the profitability of the project at time of a termination was utilized to limit a lost profit recovery. The clause at issue allowed "a fair and reasonable profit on the costs incurred in the performance of the terminated work." The contractor requested 44% profit. The government requested 19%. The court stated it considered the rate the contractor would have earned had the contract been performed to completion and the rate the parties contemplated at the time they negotiated the contract, but did not discuss the specific proof. The court noted that the contractor had exaggerated its costs to obtain a cost recovery, but stated that if the exaggerated costs were accurate then that must have meant the contractor was operating at a loss prior to termination. The court also did not agree with the contractor's proof of the amount of work performed. The court adopted the government's 19% rate (applying a simple ratio of work performed less costs), but it is unclear if the court would have even award that amount had the government not so agreed. (The court also disallowed

[52]McDonnell Douglas Corp. v. U.S., 37 Fed. Cl. 270, 274-74, 41 Cont. Cas. Fed. (CCH) P 77035 (1996).

[53]*See, e.g.,* Abadie v. Organization for Environmental Growth, Inc., 806 A.2d 1225 (D.C. 2002); *McDonnell*, 37 Fed. Cl. at 273–74.

[54]White Buffalo Const., Inc. v. U.S., 101 Fed. Cl. 1, 18 (2011).

post-termination lost profits in the absence of proof of bad faith conduct.)

As discussed earlier, a T for C clause may simply require the payment of an unspecified "fee" or "reasonable profits" as opposed to a simple reference to "costs" or "profits" or a specific negotiated percentage of mark-up on documented costs of the work performed. The parties might try to argue that such language evidences intent to not argue about the profitability of the job in question or the contractor's historical profitability or even what a standard industry fee might be. Alternatively, the parties may look to some form of parole evidence from the parties' discussion at the time the contract was negotiated.

According to one commentator, "the owner should recognize that a reasonable profit should be at least ten percent — under normal situations. In a termination for convenience situation, a reasonable profit may be higher."[55] That same commentator recommends either agreeing on a percentage ahead of time or charging a neutral party to make the decision in the event of a dispute. In the absence of an agreement, testimony on any industry standard rate (if allowed by the court) would likely need to be supplied through experts.

Another commentator team writes that profits on work performed is in one sense an "easy item to calculate" because the costs are simply marked up or multiplied by a figure that represents the profit percentage.[56] That same commentator team explains, though, that the "difficulty lies" in determining the appropriate profit percentage to use.[57] They explain that the methods for proving the profit percentage include a percentage markup based upon the original margin percentage in the original project bid, the contract rate for change orders [profit percentage on small changes may be inappropriate to extrapolate to the percentage to be used on a major claim or the job as a whole] or alternatively the contractor's average historical profits margin on similar contracts or an industry averaging margin.[58] They explain that on "all contracts and claims, however, the profit percentage should be fair and reasonable under the circumstances of

[55]Callahan, at 270; *see also* William Schwartzkopf & John J. McNamara, Calculating Construction Damages § 8.04 (2d ed. 2000) ("generally speaking, courts and boards have accepted a 10 percent profit percentage.")

[56]Schwartzkopf & McNamara, at § 8.04.

[57]Schwartzkopf & McNamara, at § 8.04.

[58]Schwartzkopf & McNamara, at § 8.04.

the projects."[59] They also add that in the absence of a contractually-specified percentage, "the profit margin may be adjusted to reflect any increase in risk or difficulty incurred."[60]

With respect to proof of lost profits, Schwarzkopf states:

> Industry studies on profit margins provide a useful reference for determining appropriate profit margins. Such information can usually be obtained through industry associations, banks, sureties, or other financial institutions. For example, Robert Morris Associates publishes extensive data on profit. The National Electrical Contractors Association (NECA) publishes an annual survey of its members listing profit margins by region and volume of the contractor. Similar studies are published by the Construction Financial Management Association (CFMA). The CFMA Reports may be less useful to specialty contractors because all specialties are lumped together in one category. CFMA Reports are most useful to general or heavy contractors and are recognized as the most comprehensive survey on construction profitability.
>
> Profit percentage rates may also be determined by reference to the contractor's historical profit margin. Historical profit margins should be readily ascertainable from the contractor's financial records and other financial data. However, a contractor's historical profit margin may not be useful if the claimed project constituted a major portion of the contractor's revenues for the previous several years. If this is the case, the contractor's historical profit margin must exclude the claimed project in order to arrive at a true historical average. As discussed in Section 8.7, below, historical averages may also be inaccurate if the contractor performed several lines of work in addition to construction.
>
> The profit margin used by the contractor in its original bid is also useful to determine the profit margin to be applied to changed work. In using this indicator, however, the bid must be thoroughly examined for errors, mistakes, or inaccuracies. Discrepancies due to mistakes in the bid may detract from the validity of the claim.

In the federal arena, it has been stated that "no monolithic formula for determining profits is available" and that "determination of the rate of profits is done on a case-by-case basis" and "is a matter of judgment."[61] As referenced earlier, the FAR 49.202(a)(b) provides a list of nine discretionary factors for regulators to consider:

(1) Extent and difficulty of the work done by the contract as

[59] Schwartzkopf & McNamara, at § 8.04.

[60] Schwartzkopf & McNamara, at § 8.04.

[61] John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts 1117 (4th ed. 2006) (citing Metered Laundry Servs., ASBCA 21573, 78-1 BCA ¶ 13,206 *modified on recons.,* 78-2 BCA ¶ 13,451); McDonnell Douglas Corp. v. U.S., 37 Fed. Cl. 270, 274-745, 41 Cont. Cas. Fed. (CCH) P 77035 (1996).

compared with the total work required by the contract (engineering estimates of the percentage of completion ordinarily should not required, but if available should considered);

(2) Engineering work, production scheduling, planning, technical study and supervision, and other necessary services;

(3) Efficiency of the contractor, with particular regard to-

- (i) Attainment of quantity and quality of production;
- (ii) Reduction of costs;
- (iii) Economic use of materials, facilities, and manpower; and
- (iv) Disposition of termination inventory;

(4) Amount and source of capital and extent of risk assumed;

(5) Inventive and developmental contributions, and cooperation with the Government and other contractors in supplying technical assistance;

(6) Character of the business, including the source and nature of materials and the complexity of manufacturing techniques;

(7) The rate of profit that the contractor would have earned had the contract been completed;

(8) The rate of profit both parties contemplated at the time of the contract was negotiated; and

(9) Character and difficulty of subcontracting, including selection, placement, and management of subcontracts, and effort in negotiating settlements of terminated subcontracts.

These factors provide a useful checklist for counsel to consider in private contract disputes even where the FAR does not apply. They also might be taken into account on the front-end negotiation of the T for C clause.

B. Contractor's Overhead and General Conditions

Related to profit, but also often separately called out in T for C clauses, is overhead. Consideration of overhead leads to special concerns. As one commentator points out, termination for convenience situations can lead to disparate impacts on a contractor's overhead.[62] For example, the termination might occur just after the high overhead portion of the project was completed and before the contractor was able to shift to the lower overhead and higher

[62] Michael T. Callahan, Termination of Construction and Design Contracts chs. 7.04[B][2] (2011).

profitability portion of the work where the contractor planned to achieve the ability to absorb its overhead costs.[63]

Many contractors argue that overhead is simply another type of cost that should be treated as reimbursable and recoverable in a termination for convenience even if the T for C clause does not expressly address overhead. An owner will counter that overhead is an accounting fiction and a surrogate for additional unearned profit. An owner may also be rightly concerned about duplication between amounts allocated to "overhead" versus "general conditions" versus "general and administrative expenses."

Interestingly, many of the "standard" forms expressly allow some kind of overhead recovery, but in different ways. The ConsensusDOCS 200 T for C clause expressly allows recoverability of "overhead" on work performed but expressly excludes overhead on work not performed. The EJCDC C-700 T for C clause expressly allows recovery of overhead on both work performed and work not performed. The AIA A202 is silent with respect to overhead on work performed, but expressly permits recovery for overhead on work not performed. Certain federal cases have allowed unabsorbed overhead recoveries even though the termination for convenience regulations neither exclude nor expressly allow them.[64]

The different types of recognized overhead complicate drafting efforts. Does a provision allowing recoverability of "overhead" include both home office overhead and job site overhead? How would either type of overhead attributable to a T for C be calculated, and is the calculation different for work performed versus work not performed? In the case of a T for C clause such as the AIA's that calls for recovery of overhead on work not performed, but is silent with respect to overhead on work performed, is overhead on work performed recoverable? Under the AIA clause, is job site overhead on the part of the work performed (like profit) impliedly intended to be recoverable as part of the recovery of the payment for the work executed?

Do clauses allowing recoverability of "profit on" or "value of" or "costs of" the "work" include overhead if overhead is not specifically mentioned? Does "price of the work" include an additional

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[63] Michael T. Callahan, Termination of Construction and Design Contracts chs. 7.04[B][2] (2011).

[64] Nicon, Inc. v. U.S., 331 F.3d 878, 885–86 (Fed. Cir. 2003).

amount of overhead (and profit)? Does "value of the work" imply some sort of *quantum meruit* type recovery?[65]

A contractor would likely argue that a provision that allows recoverability of "costs" includes overhead. An owner will likely argue that at most "costs" means direct material and labor costs and does not include either home office overhead or perhaps even certain types of jobsite overhead (which the owner would likely argue are "indirect" costs).

Although one has to be careful in private contracting situations about analogizing to the federal contracting cases interpreting the FAR, the federal arena provides some potential guidance on these points. One commentator observes that the federal termination for convenience clause permits recovery of the contract price for completed services or supplies accepted, which "generally . . . means actual costs plus profit and overhead attributable to the actual costs."[66] Another commentator writes that "[e]xcept to the extent that it is allocable to direct settlement expenses, recovery of post-termination overhead has been prohibited in termination clause for completely terminated contracts."[67] Additionally, courts in the federal contracting arena have said that home office overhead constitutes an "indirect cost" whereas field office overhead is a direct cost.[68]

One court, in *Nicon, Inc. v. United States*, explained it this way:

> Direct costs are those costs that are directly attributable to the performance of a specific contract and can be traced to that contract. *Charles G. Williams Constr., inc. v. White*, 271 F.3d 1055, 1057–58 (Fed. Cir. 2001). Indirect costs include such things as home office overhead, defined as costs 'that are expended for the benefit of the whole business, which by their nature cannot be attributed or

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[65] *See also* Quality Asphalt Paving, Inc. v. State, Dept. of Transp. and Public Facilities, 71 P.3d 865, 877–78 (Alaska 2003) (court upholds partial recovery of overhead in termination for convenience and explains meaning of clause that allows recovery for "overhead expenses directly allocable to the project termination and not covered under work paid for at agreed unit prices or contract bid price").

[66] Callahan, at 3.10[C] at 60.

[67] John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts 1114 (4th ed. 2006) (citing Nolan Bros., Inc. v. U. S., 194 Ct. Cl. 1, 437 F.2d 1371 (1971) and other authority).

[68] George Sollitt Const. Co. v. U.S., 64 Fed. Cl. 229 (2005) (discussed overhead in delay context); Blinderman Const. Co., Inc. v. U.S., 39 Fed. Cl. 529, 42 Cont. Cas. Fed. (CCH) P 77210 (1997), aff'd, 178 F.3d 1307 (Fed. Cir. 1998); Wickham Contracting Co., Inc. v. Fischer, 12 F.3d 1574, 39 Cont. Cas. Fed. (CCH) P 76608 (Fed. Cir. 1994) (discusses overhead in delay context).

charged to any particular contract.' *Altmayer v. Johnson*, 79 F.3d 1129, 1132 (Fed. Cir. 1996) Generally, a contractor recovers these indirect costs by allocating a proportionate share to each of its contracts."[69]

In *Nicon*, a contractor terminated for convenience sought recovery of unabsorbed home office overhead resulting from a delay period between the award of the contract and the termination, during which time the contractor claimed it was required to be on standby. The Court of Claims granted summary judgment for the government and the Federal Circuit Court of Appeal reversed and remanded. The appellate court held that the contractor could recover unabsorbed overhead costs if a) a reasonable method of allocation could be determined on what were unusual facts and b) the contractor could otherwise satisfy strict prerequisites for recovery of unabsorbed overhead costs. The unusual facts were that, unlike many situations where performance of a contract resumes after a delay, here the contractor was terminated after a lengthy delay period and the contractor was never able to perform work. The perceived problem was that in a situation in which there was no performance, there was no way to determine the length of time by which the government's delay would extend performance.[70]

The *Nicon* court also provides an interesting justification for the recovery of home office overhead under the regulations, which the court noted neither expressly allow, nor disallow, unabsorbed overhead. The court discussed the history of the *Eichleay* calculation as a method in federal contracting for compensating contractors for government-caused delay, and the very specific requirements of the *Eichleay* formula. The court however did not want to be locked in by the formalistic rules of the *Eichleay* test when the circumstances seemed to justify a recovery.[71] The court went on to provide a lengthy contractual/regulatory analysis of why a recovery of unabsorbed overhead "fairly compensated the contractor for costs incurred with the terminated work." The court wrote:

A contractor may seek to recover damages for unabsorbed overhead as part of the termination for convenience settlement,

[69]Nicon, Inc. v. U.S., 331 F.3d 878, 882 (Fed. Cir. 2003); *see also* The Redland Co., Inc. v. U.S., 97 Fed. Cl. 736, 746 (2011) ("Home office overhead is among a contractor's indirect costs . . ."); Singleton Contracting Corp. v. Harvey, 395 F.3d 1353 (Fed. Cir. 2005) (government acknowledges contractor terminated for convenience was entitled to recover overhead on it direct costs but contractor failed to submit the required proof).

[70]*Nicon*, 331 F. 3d at 884.

[71]*Nicon*, 331 F. 3d at 882–85.

and, if the contracting officer denies these damages, appeal the unsatisfactory settlement amount. *Cf. James M. Ellett Constr. Co. v. United States,* 93 F.3d 1537, 1542–46 (Fed.Cir.1996) (explaining the process by which the contracting officer's rejection of a termination settlement proposal can become an appealable claim). The burden is then on the contractor to show that it is actually entitled to a settlement amount in excess of that determined by the contracting officer. *Gen. Dynamics Land Sys., Inc.,* 02-1 B.C.A. (CCH) ¶ 31,659, at 156,411 (A.S.B.C.A. Nov.20, 2001). Although the burden is on the contractor to show entitlement to a larger settlement amount, it must be kept in mind that the overall purpose of a termination for convenience settlement is to fairly compensate the contractor and to make the contractor whole for the costs incurred in connection with the terminated work. *Freedom Elevator Corp.,* 85-2 B.C.A. (CCH) ¶ 17,964, at 90,032 (G.S.B.C.A. Feb.28, 1985). Settlement agreements are intended to compensate the contractor fairly, which "is a matter of judgment and cannot be measured exactly." 48 C.F.R. § 49.201(a) (2002); *see also id.* § 49.201(c) ("Cost and accounting data may provide guides, but are not rigid measures, for ascertaining fair compensation."); *Codex Corp. v. United States,* 226 Ct.Cl. 693, 698 (1981) (discussing the fairness policy embodied in the predecessor to § 49.201). The regulations provide that the cost principles in Part 31.2 of the Federal Acquisition Regulations ("FAR") are to "be used in asserting, negotiating, or determining costs relevant to termination settlements," but they are subject to the general fairness principles of section 49.201(a). 48 C.F.R. § 49.113 (2002).

Although unabsorbed overhead is not specifically listed in the FAR's "Termination for Convenience of the Government (Fixed-Price)" clause as one of the costs that will be paid under a settlement, it is also not excluded anywhere and could be asserted under the category of "costs incurred in the performance of the work terminated, including *initial* cost and preparatory expense allocable thereto." 48 C.F.R. § 52.249-2(g)(2)(i) (2002) (emphasis added). Furthermore, although unabsorbed overhead is not mentioned in 48 C.F.R. § 31.205-42 as a cost peculiar to a termination situation, the costs listed there "are to be used in conjunction with the other cost principles in subpart 31.2," none of which would appear to prevent, as a matter of law, the award of unabsorbed overhead damages in a termination for convenience settlement if they are properly allowable and allocable. Unabsorbed overhead damages have been held to be allowable in the context of a termination for convenience settlement, *see Worsham Constr. Co.,* 85-2 B.C.A. (CCH) ¶ 18,016, at 90,369 (A.S.B.C.A. Mar.22, 1985), and we see nothing in the regulations that would preclude the inclusion of unabsorbed overhead damages in the settlement if the factual situation is one in which a reasonable allocation method can be discerned. This is especially so in light of the FAR's admonition that "[t]he use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement." 48 C.F.R. § 49.201(a) (2002). The FAR also provides that "[i]n appropriate

> cases, costs may be estimated, differences compromised, and doubtful questions settled by agreement." *Id.* § 49.201(c). In construing these regulatory guidelines, it is "axiomatic that . . . one must strike a balance between the need for technical compliance with regulatory requirements and the need for basic fairness." *Spectrum Leasing Corp. v. Gen. Servs. Admin.,* 95-1 B.C.A. (CCH) ¶ 27,317, at 136,185–86 (G.S.B.C.A. Nov.8, 1994).[72]

Another issue is that neither the AIA A201, the EJCDC C-700 nor the ConsensusDOCS 200 clauses reference is the recoverability of "general conditions" costs, even though some contractors include job-site overhead or even home office overhead in sections of their bids or schedules of value labeled as "general conditions." What happens if the T for C clause only references either "general conditions" or "overhead" (or neither)? The contractor in *Winmar*, *supra*, claimed that it was entitled to 100% of the line item entitled "General Conditions Overhead and Fee."[73] The court found that the contractor was entitled to a portion (based on the percentage of work completed) of the "General Conditions Overhead and Fee," but not the remaining portion of the "General Conditions Overhead and Fee" for work not completed. As to that remaining portion, the court found that the contractor's failure to break out overhead from fee, and failure to offer any proof of actual "reasonable overhead and profit" amounts beyond the contracted line-item, did not meet the contractor's burden of proof.[74]

Lastly, there is the issue of the method of calculation of overhead. (The method of proving overhead, which comes up in numerous contexts besides terminations for convenience, will be discussed separately in a later installment of this series.) Suffice it to say that overhead calculations can be hotly contested, in federal, state, and private contacting scenarios. Although rarely done, drafters looking to avoid this type of dispute can choose to specify the method of calculation within the contract.

C. Contractor's "Costs" of Work Performed

Putting aside the issues of whether "costs" includes profit or overhead, there seems little doubt that a contractor terminated for convenience who is not itself in breach and not performing at

[72] *Nicon*, 331 F. 3d at 885–86.

[73] Winmar, Inc. v. Al Jazeera Intern., 741 F. Supp. 2d 165 (D.D.C. 2010), judgment amended on other grounds, 813 F. Supp. 2d 163, 80 Fed. R. Serv. 3d 1034 (D.D.C. 2011), vacated in part on other grounds, 831 F. Supp. 2d 159 (D.D.C. 2011).

[74] *Winmar*, 741 F. Supp. 2d at 195.

a loss can argue for recovery of its costs under a variety of legal theories.

There are, however, theoretical limits on even cost recoveries. The term "costs" most obviously applies to direct labor and material costs on the job, but may be held to exclude "indirect" costs including settlement costs, certain bid-related pre-project costs, expenses directly caused by the termination, or other post-termination costs. As discussed above, loss adjustment provisions may be crafted to apply to costs as well as profits. Also, the recoverability of certain types of costs may depend on the theory of recovery a court adopts. A reliance-type approach might entitle the contractor to lost opportunity costs and other pre-contract expenses; a *quantum meruit* type theory might only recognize costs and profits on the work performed with reasonable profits that may or may not be large enough to cover pre-contract expenses.

Owners may well seek to impose contractual caps and other limitations on cost recoveries. This is the approach of the FAR, which requires that costs recoverable under a convenience termination be reasonable, and defines costs as reasonable if "in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business."[75] Additionally, the total contract price acts as a cap on the allowable recovery.[76]

In *OFEGRO*, the District of Columbia Court of Appeals upheld contract terms capping costs (excluding settlement costs) at the total contract price.[77] The contract at issue provided:

> [T]he Contractor and Contracting Officer may agree upon the whole or any part of the amount or amounts to be paid to the Contractor by any reason of the total or partial termination of work pursuant to this Article . . . provided, that such agreed amount or amounts, exclusive of settlement costs, shall not exceed the total Contract price as reduced by the amount of payments otherwise made and as further reduced by the Contract price of work not terminated.[78]

The court noted that, "OFEGRO has already been paid $127,273.49 for the work it completed on this contract. While the absolute maximum that could be paid to OFEGRO in termination costs is $165,801.57 (the difference between the contract price and the amount already paid), the actual payment may turn out

[75] FAR 31.201-3.

[76] FAR 49.207.

[77] District of Columbia v. Organization for Environmental Growth, Inc., 700 A.2d 185, 202–03 (D.C. 1997). ("OFEGRO")

[78] OFEGRO, 700 A.2d at 202.

to be far less, considering the pay-as-you-go nature of the contractual relationship."[79]

However, not all Courts uphold contractual caps on cost recoveries. *Jacobs Engineering Group, Inc. v. United States*[80] is an example of a court failing to follow a contractual cap. *Jacobs* involved a contract with the government to develop, design and build a gasification improvement facility. The contractor had agreed to accept a contractual T for C payment of 80% of costs in consideration for patent rights and other benefits. When the government terminated because it did not have funds for performance, the contracting officer rejected *Jacobs'* claim for 100% of its costs. The Court of Claims granted the government's motion for summary judgment and thus upheld the rejection. The Federal Circuit reversed the decision to only reimburse Jacob's at the 80% level, reasoning that due to the termination the benefit of the patent rights was never obtained. It also disagreed with the lower court's interpretation of some "all costs" language in the T for C clause. It appears the court was influenced by the "basic financial situation underlying the contract" and the related equities.

The federal framework is replete with regulations defining costs and a rich history of case law interpreting those regulations.[81] Because the federal regulations are so specific, they may have little or no applicability to certain state or private contracting situations. Principles in the federal case law can, however, be instructive. One recent decision summarized the FAR this way:

> When a contract is terminated for convenience, pursuant to 28 C.F.R. § 52.249-2(g)(2), a party may recover the total of (1) "[t]he costs incurred in the performance of the work terminated, including initial costs and preparatory expense allocable thereto," (2) [t]he cost of settling and paying termination settlement proposals under terminated subcontract that are properly chargeable to "the terminated portion of the contract," and (3) a fair and reasonable

[79] OFEGRO, 700 A.2d at 202–03.

[80] Jacobs Engineering Group, Inc. v. U.S., 434 F.3d 1378 (Fed. Cir. 2006).

[81] *See, e.g,* Philip L. Bruner & Patrick J. O'Connor, Jr., Bruner and O'Connor on Construction Law n.6 (2002); Michael T. Callahan, Termination of Construction and Design Contracts chs. 3, 6, 7 (2011); John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts ch. 11 (4th ed. 2006); Damages and Amount of Recovery Awardable to Government Contractor Upon Termination of Contract for Convenience, 12 A.L.R. Fed. 2d 551. *See also* FAR 31.205-42(c) (lists allowable initial costs, including training, plant rearrangement, production planning and idle time due to production methods testing).

> profit on the costs incurred in the performance of the terminated work. *Id*. As the contract is being terminated at the convenience of the government, costs are allowable and recoverable. Factors to be considered by the Court in its determination of allowable costs include: (1) reasonableness; (2) allocability to the contract; (3) generally accepted accounting principles and practices; (4) the terms of the contract; and (5) any specific limitations set forth in FAR part 31. *White Buffalo Constr.,* 51 Fed.Cl. at 4 & n. 7. The Court will take each cost in turn.[82]

In *White Buffalo*, a contractor sought damages from the termination of an FHA contractor to repair damaged roads in a National Forest.[83] The court awarded direct labor costs (but not those for post-termination supervision of the use of its equipment by another contractor) and amounts for equipment, fuel, and vehicle costs (but not damage to equipment that the contractor could not prove occurred during performance of the contract).

An excellent and detailed multi-page discussion of recoverable costs under the FAR, as interpreted by case law, appears in Cibinic, et al. and need not be repeated here.[84] It is particularly interesting though that "recurring termination cost problems" called out by Cibinic et al. include:

– common items reasonably usable on other projects;
– costs continuing after termination which cannot be discontinued;
– "initial" costs such as preparatory cost incurred (but not bid and proposal costs) in preparing to perform the contract such as initial plan rearrangement and alternative, management and personal organization and production planning in preparing to perform the contract and un-abandoned starting load costs resulting from training, subnormal products due to testing; and other facts;
– loss of value of special tooling, machining and equipment not reasonable capable of re-use;
– rental costs for premises;
– costs for settling subcontractors' claims; and
– costs of producing termination inventory.

By contrast, termination for convenience clauses in private contracts often do not define recoverable "costs" — at all or in

[82] White Buffalo Const., Inc. v. U.S., 101 Fed. Cl. 1, 18 (2011); FAR 52.249-2(g)(2).

[83] White Buffalo Const., Inc. v. U.S., 101 Fed. Cl. 1 (2011).

[84] John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts ch. 11 (4th ed. 2006).

any detail The AIA, ConsensusDOCS and EJDC forms are examples. This also is particularly true with lump sum contracts where there may be no perceived need to define "cost." However, definitions of "Costs" in cost-plus contracts are at least available to apply to the calculation of costs in termination for convenience situations. If such definitions are used, however, care might need to be taken to consider whether the definition makes sense in a termination for convenience setting and whether "including but not limited to" language is appropriate.

The burden of proof is usually on the terminated contractor to prove costs.[85] Some courts, applying federal regulations, have stated that the costs must be proven to not only have been incurred but to be reasonable and allocable to the contract.[86] The *Abadie, III* court, which rejected the contractor's proof, described the burden this way:

> A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective* competitive restraints. *No presumption of reasonableness shall be attached to the incurrence of costs by a contractor*. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, *the burden of proof shall be upon the contractor to establish that such cost is reasonable*. 48 C.F.R. § 31.201-3 (2002).[87]

Methods of proving costs vary. Accounting records documentation such as cost detail reports, labor, material, equipment and subcontract records and pay applications are frequently used to prove-up costs. Some courts allow estimates if accounting records are not available.[88]

Of course, burdens of proof can be outcome-determinative, especially where documentation is incomplete or the method of calculation or the credibility of fact or expert witnesses is subject

[85] Cibinic et al., at 1090–91 (citing cases).

[86] Abadie v. Organization for Environmental Growth, Inc., 806 A.2d 1225, 1230 n.14 (D.C. 2002) (citing Hydrothermal Energy Corp. v. U.S., 26 Cl. Ct. 1091, 1104, 38 Cont. Cas. Fed. (CCH) P 76423, 1992 WL 312153 (1992)).

[87] *Abadie, III*, 806 A.2d at 1227–28.

[88] Cibinic et al.(citing FAR 49.206(c)); Bailey Specialized Bldg., Inc., ASBCA 10576, 71-1 BCA ¶ 8699 (1971). Jason Richey, The Termination for Convenience Clause: A Powerful Weapon in Contractual Disputes, K & L Gates Construction Law Blog, nn.55–56 (Dec. 1, 2007), http://www.klconstructionlawblog.com/2007/12/articles/articles-and-publications/the-termination-for-convenience-clause-a-powerful-weapon-in-contractual-disputes/.

to dispute. This was the case in *Winmar*, *supra*, a decision that methodically addressed multiple cost items in the schedule of values. The court generally accepted as *prima facie* evidence of the extent of work performed the amounts and percentages of completion contained in payment applications certified by an architect. The court was concerned that the architect did not testify at trial and noted various "discrepancies" in the pay applications, but found, nonetheless, that the certifications met the contractor's *prima facie* burden. The court held in many instances that the *prima facie* evidence was not rebutted by project photos and testimony of an expert "professional estimator" retained by the owner who provided very different assessments of the percentage of completion of the work. The court noted that the expert made erroneous assumptions and mis-categorizations of work, which cast doubts about his credibility.[89]

D. Settlement and Termination Costs

Various clauses regulations and rules distinguish "settlement costs" and "termination costs" from costs of the work. All of the standard form contracts explicitly allow for recovery of settlement or termination costs in some form or fashion. The ConsensusDOCS provide recovery for "all demobilization costs and costs incurred as a result of the termination." The EJCDC permits recovery for costs for settlement with subcontractors and for reasonable expenses directly attributable to the termination. The FAR for construction contracts provides for recovery of reasonable costs for settlement of the work terminated including (i) accounting legal, clerical and other expenses reasonably necessary for preparation of settlement proposals, (ii) termination and settlement of subcontracts, and (iii) storage and other costs necessary for protection of inventory. Under the FAR, settlement proposals can be based on an "inventory" basis (the preferred method) or a "total cost" basis.[90] Under either calculation method, the contractor must set forth costs of settlement with subcontractors and settlement expenses. In more ambiguous language the AIA specifically allows for recovery of "costs incurred by reason of such termination."

Although each of the standard form contracts permits recovery

[89] Winmar, Inc. v. Al Jazeera Intern., 741 F. Supp. 2d 165, 195 (D.D.C. 2010), judgment amended on other grounds, 813 F. Supp. 2d 163, 80 Fed. R. Serv. 3d 1034 (D.D.C. 2011), vacated in part on other grounds, 831 F. Supp. 2d 159 (D.D.C. 2011).

[90] John Cibinic, Jr., Ralph C. Nash, Jr., & James F. Nagle, Administration of Government Contracts ch. 11, 1080 (4th ed. 2006).

for settlement and termination recovery of some kind, there are potentially important distinctions in approach taken and ambiguities in the various standard forms. The EJCDC and the FAR both impose an explicit "reasonableness" standard on recovery for settlement and termination costs. The Consensus-DOCS, by contrast, allow recovery for "all costs" incurred as a result of the termination, and the AIA allows recovery for simply "costs;" neither of these two form agreements explicitly requires reasonableness. Another distinction is that while the AIA, ConsensusDOCS, and the FAR each refer to settlement or termination "costs," the EJCDC instead references "expenses." Whether "expenses" and "costs" are one and the same is not a question that has been addressed by the courts, but an owner may try to argue that "expenses" are narrowly defined while a contractor would argue that "expenses" are all-encompassing.

Red River, *supra*, is a case that addresses whether under contrasting regulations there is a meaningful difference between the term "reasonable costs" versus "reasonable charges" resulting from a termination.[91] The terminated contract in *Red River* was a commercial paper contract, which has a different T for C clause than the federal construction contracts. Rather than requiring payment of "reasonable costs" as in the construction T for C, the commercial paper T for C requires payment of "reasonable charges" that have resulted from the termination. The other component of damages in the T for C commercial paper context is a payment based on the percentage of work performed. The court in *Red River* found that this difference in terminology is significant.[92] At issue was the recoverability of amounts for loan principal, interest and insurance payments, depreciation, shipyard costs, general and administrative expense and profit. The Navy argued that "reasonable charges . . . [that] have resulted from the termination" encompass only those costs incurred *subsequent* to the termination (*i.e.*, settlement costs and wind-down expenses such as accounting, legal, and clerical expenses), and therefore none of Red River's claimed expenses—including loan principal, interest, insurance costs, modification cost, general and administrative expenses, and profit—were compensable because they were costs incurred prior to the termination itself. The Navy also was concerned that the asset remained available for use in future engagements. The contactor argued "reasonable charges" in a regulation included any reasonable

[91] Red River Holdings, LLC v. U.S., 802 F. Supp. 2d 648 (D. Md. 2011).

[92] *Red River*, 802 F. Supp. 2d at 655 n.8.

costs incurred in anticipation of contract performance that but for the termination would have been recouped. The court found that both the Navy and the contractor's arguments were "wide of the mark" and held that the contractor should be able to recover compensation for settlement costs or costs reasonably incurred in anticipated of contract performance, provided such costs are not adequately reflected as a percentage of the work performed, and provided such costs could not have been reasonably avoided.[93] In short, the court found that "reasonable charges" are broader than just post-termination charges, but narrower than all costs that would have been collected had the contract not been terminated. The key determination is whether the costs at issue are (or are not) adequately reflected as a percentage of the work performed. If not, and provided the costs could not have been reasonably avoided, the court held that those costs can be collected as part of the "reasonable charges" that resulted from the termination.

E. Can an Owner Set-Off Amounts Against or Recover Damages From the Contractor in a Termination for Convenience Situation

As discussed at length above, usually when a contract is terminated for convenience, the contractor is entitled to recover some measure of damages. Another matter, though, is whether the <u>owner</u> can recover set-off amounts or recover damages where the work was defective. Think, for example, about Variation 3 where the Owner suspects that some of the work might be defective, but terminates the contract for convenience in the hopes of avoiding a big litigation expense. If that work turns out to be defective, can the Owner collect damages or off-set the amount due to the GC under the terms of the T for C clause? The standard forms do not expressly address whether a contractor may set-off, and courts have been inconsistent on this issue, leaving more questions than answers when it comes to owner recovery under a T for C clause.[94]

In *Tishman Construction Corp. v. City of New York*, the City of New York terminated a contract under a T for C clause, which limited the contractor's recovery to only those payments due and

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[93] *Red River*, 802 F. Supp. 2d at 659, 662.

[94] Tishman Const. Corp., Inc. v. City of New York, 228 A.D.2d 292, 643 N.Y.S.2d 589 (1st Dep't 1996) (owner could not prevail on a counterclaim for defective work where the owner terminated the contract under a T for C clause); United Partition Systems, Inc. v. U.S., 90 Fed. Cl. 74 (2009) (contractor's recovery was limited because the owner was not required to pay for work that did not conform to the contract).

payable on the date of the termination.[95] The contractor brought a suit against the city, and the city brought a counterclaim for damages for allegedly defective work. The court found that the city could not pursue those counterclaims, reasoning that had the city wanted to bring those claims, it could have terminated the agreement for default.[96] *Tishman* reasoned that such a claim would be inappropriate since the act of terminating deprives the contractor of the opportunity to cure and complete the project.

In contrast to the approach taken by *Tishman*, in *United Partition Systems, Inc. v. United States*, the court allowed a set-off of for a nonconforming wall partition when that wall partition failed to meet the fire rating required under the contract.[97] In *United Partition*, the court found that the Air Force had wrongfully declared a termination for default because it terminated the contract before any testing was done on the wall to determine whether it actually met the required fire rating. The termination was therefore converted to a termination for convenience. Later testing showed that the wall did not meet the required rating, and therefore was defective under the contract. The court did not require the Air Force to pay for the nonconforming wall partition.[98]

Likewise, in *EPC Corp.*, *supra*, the court allowed a contractor to offset sums due to a subcontractor under a termination for convenience where the work done by the subcontractor was allegedly defective.[99] The T for C clause at issue allowed the subcontractor to collect "for that Work actually performed *in an amount proportionate to the sum payable under [the] Agreement*" and the subcontract also expressly permitted the contractor to offset any sums due to the subcontractor by the amount of any backcharges or unpaid obligation s of the subcontractor to the contractor.[100] The court found that the contract's language as to backcharges to

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[95] Tishman Const. Corp., Inc. v. City of New York, 228 A.D.2d 292, 643 N.Y.S.2d 589 (1st Dep't 1996).

[96] *Tishman*, 228 A.D.2d at 293.

[97] United Partition Systems, Inc. v. U.S., 90 Fed. Cl. 74 (2009).

[98] *See also* Paragon Restoration Group, Inc. v. Cambridge Square Condominiums, 42 A.D.3d 905, 906, 839 N.Y.S.2d 658 (4th Dep't 2007) (holding that "where defendant elects to terminate for convenience whether with or without cause, it cannot counterclaim for the cost of curing any alleged default").

[99] U.S. ex rel. EPC Corp. v. Travelers Cas. & Sur. Co. of America, 423 F. Supp. 2d 1016, 1025–27 (D. Ariz. 2006).

[100] *EPC Corp.*, 423 F. Supp. 2d at 1026.

be "straightforward" and also found that common-sense and fairness require an offset.[101]

IV. Termination for Convenience by a Contractor

It is somewhat rare for a contractor to have the right to terminate for convenience because many owners simply will not allow a contractor to bargain for a termination for convenience right. Therefore, the application of such a clause is relatively unknown. However, contractors and owners should be aware that some forms do provide certain contractor termination options.

The ConsensusDOCS provide (in § 11.53) a right to the Contractor to terminate for various reasons not the fault of the contractors: Upon termination by the Contractor in accordance with Section 11.5 [specified reasons not at contractor's fault], the Constructor shall be entitled to recover from the Owner payment for all Work executed and for any proven loss, cost, or expense in connection with the Work, including all demobilization costs plus reasonable Overhead and profit on Work not performed." Likewise, in section 14.1.3 of the AIA A201, the Contractor is given the parallel right to terminate (in the case of certain specified events such as specified severe delays or specified acts of the Owner) and recover from the Owner payment for Work executed, including reasonable overhead and profit, costs incurred by reason of such termination, and damages.

These provisions are limited, and do not allow contractors rights parallel to owners to terminate for convenience. Such a parallel right would raise several questions. Could a contractor terminate if another, more profitable job came along? Could a contractor terminate after he had completed the most profitable portion of the job, leaving only the less-profitable work to be done? What about the GC in Variation 2 who suspects that it blew its estimate when out-of-the-box productivity is less than expected — could that GC terminate for convenience to avoid losing money? Because these clauses are rarely included in contracts and there is little or no case law addressing the application of these clauses, the answers to the questions posed above are best left for another day. Contractor and Owner terminations for cause, however, will be discussed in detail in a later installment in this series.

V. Conclusion

So, what are the lessons in all of this for drafters and negotiators of T for C clauses? First, parties should not be under any

[101] *EPC Corp.*, 423 F. Supp. 2d at 1026–27.

misimpression that a "standard form" T for C clause constitutes the contracting norm, particularly in private projects. Based on a review of the AIA, ConsensusDOCS, and EJCDC T for C clauses, it seems fair to conclude that no standard approach for drafting T for C clauses has emerged. In fact, many different approaches and compromises are illustrated when comparing the existing "standard form" T for C clauses.

Second, the T for C clauses that have emerged in the "standard form" agreements contain potential ambiguities. Some of the clauses are still relatively new and more time may be needed before such ambiguities are fully tested by the appellate courts. Ambiguous clauses might not be bad choices in certain situations, but drafters need to be aware of and them and consider their impact on their clients' interests before using them.

Third, although the likelihood of a T for C clause ever being invoked can seem remote, T for C clauses should not be treated as after-thoughts. When T for C options are invoked, the potential damages issues can be significant and the result onerous if improper thought is given to the clauses in the first instance. Drafters may need to consider such factors as the type of project at issue, the investment a contractor is being asked to make in projects, the ability and incentives an owner may have to invoke the clause and how the clause would be applied and recoveries calculated if the clause is ever invoked.

So back to our variations 1, 2 and 3. Were the financing problems or process design problems in scenarios 1 and 2 foreseeable? What investments was the GC really required to make and why wouldn't the owner on the front-end be willing to have allowed the contractor to protect itself in the event of a T for C if the owner found a lower-margin replacement contractor?

The owner in variation 3 might have benefited from negotiating for a conversion provision, but even with such a clause the parties in that situation seem destined for years of litigation. Perhaps a walk-away clause where the contractor received a cost-plus type of recovery but not anticipatory profits on work not performed would have worked.

In all three scenarios, query whether the parties would have been surprised by the results if any of the clauses in the standard form agreements had been used? Would the owner in variation 2 have been burned by not adopting express disclaimers of overhead and profit? Would the contractor who needed to recapture initially high overhead costs have been fairly compensated by a clause merely allowing recovery of "costs"? Would the contractor in variation 2 that was feeling lucky in light of the

termination have received a windfall if allowed a cost-plus recovery plus profit on work not performed or would the owner have been able to offset cost-plus payments with a loss adjustment? Would the owner in Variation 3 be allowed to offset amounts paid for defective work? Is the project of a type where profitability will be able to be documented and calculated?

Of course no one may know going into a construction project the side of some of these issues on which they may end up. Maybe in the end a compromise that seems fair ahead of time is all that can be negotiated. The message of this article is to go into a negotiation with eyes open.