Thinking About Terminating a Subcontractor? –
Here are a few Things to Consider
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You're a general contractor on a large, lump sum project with a tight schedule. You're half way into the project, and a major subcontractor is causing serious problems by being behind schedule and by not coordinating its work with other trades. You'd like to terminate the subcontractor and hire a replacement to finish the work. Can you? Should you? How do you do it "legally"? What are the potential consequences? This article briefly discusses some of the relevant issues.

Deciding whether to terminate a subcontractor for inadequate performance is one of the most difficult and risky decisions a general contractor can face, both from a legal and practical perspective. As a result, a subcontractor generally should be terminated only for major, recurring performance problems, and only after all avenues for getting the subcontractor to perform have been exhausted. If termination is necessary, the general contractor should attempt to reach agreement with the subcontractor on terms for the termination. However, if the general contractor is forced to terminate a subcontract without the subcontractor’s consent, the termination must be carried out properly in order to minimize the general contractor’s risks and preserve its rights.

OWNER/ARCHITECT APPROVAL

To determine whether it has the right to terminate a subcontractor, the general contractor should start by reviewing its contracts. An initial issue is whether the owner and/or architect has the right to object to a particular replacement subcontractor. For example, paragraph 5.2.4 of AIA Document A201-1997 (General Conditions of the Contract for Construction) provides that “the Contractor shall not change a Subcontractor, person or entity previously selected if the Owner or Architect makes reasonable objection to such substitute.” Thus, the general contractor may have to obtain the owner’s and/or architect’s consent to change subcontractors. This consent should be obtained in writing.

GROUNDS FOR TERMINATION

Another key issue is whether adequate grounds exist to terminate the subcontractor. Most subcontract agreements give some guidance regarding grounds for terminating the subcontractor and may list such items as failure to adequately staff the work, supply adequate and conforming materials, meet the schedule, pay laborers, subcontractors and suppliers, and comply with code and safety requirements as grounds for termination.

Regardless of the particular terms of the subcontract, the law generally permits a party to terminate a contract only when the other party has committed a very serious, or “material”, breach of the contract. A minor or technical breach of the contract will not justify termination, and termination is not appropriate where the subcontractor has substantially performed its contractual obligations.

For example, a subcontractor’s delay of a few days in meeting certain schedule milestones, under most circumstances, would not constitute a “material” breach justifying termination. The general contractor may have a claim for damages caused by the subcontractor’s brief delay (for example, if the owner assessed liquidated damages), but it probably would not be justified in terminating the subcontractor from the project.

A more difficult question -- one with no easy answer -- is whether a subcontractor’s failure to complete punch list items constitutes a material breach, especially where substantial completion has been achieved or a certificate of occupancy has been issued. Generally, failure to complete punch list work is not a material breach justifying termination. However, a subcontractor’s persistent failure to perform punch list work may constitute a repudiation of the contract, supporting a termination for default.

PRACTICAL CONSIDERATIONS

Of course, just because the general contractor may have a legal grounds to terminate a subcontractor does not mean that such action would be prudent under the circumstances. Some of the practical
Considerations involved in deciding whether to terminate a subcontractor are obvious: whether a replacement subcontractor can be obtained to complete the work at a reasonable price; whether the replacement subcontractor will perform any better than the terminated subcontractor; whether the project will be delayed; whether the warranty (either from the subcontractor or a supplier) will be impaired; and whether the terminated subcontractor will file a mechanics’ lien and thereby potentially damage the relationship between the owner and the general contractor. These and other important practical issues should be carefully considered before deciding to terminate a subcontractor.

Because of the potential major consequences, a subcontractor should be terminated only as a “last resort”, after other default remedies have been considered. The general contractor should first ask the subcontractor for a “cure and complete” plan, or discuss with the subcontractor other possible ways to cure the default. The general contractor should also consider other less drastic remedies short of termination, including supplementing the subcontractor’s workforce, deleting portions of the subcontractor’s work by deductive change order, and asking the surety to finance the contractor’s completion.

**PROCEDURE FOR PROPER TERMINATION**
After determining that adequate grounds exist to “legally” terminate a subcontractor and that termination is prudent from a practical perspective, the general contractor should carefully follow the notice and other procedural requirements for termination contained in the subcontract agreement. For example, paragraph 7.1.1 of AIA Document A401 (Subcontract Agreement), requires two seven-day written notices before the subcontractor can be properly terminated.

The first seven-day notice required by the AIA A401 form is intended to provide the subcontractor an opportunity to cure the default. The general contractor’s notice should state that the subcontractor is in default of its obligations under the subcontract and should describe in detail the items that must be cured. If the subcontractor is bonded, the bonding company should also be notified of the default.

Frequently, a default notice will be enough to get the subcontractor’s “attention” and cause the subcontractor to cure the default. However, if the subcontractor does not adequately cure the default and the general contractor wishes to proceed with the termination, the general contractor should comply with any additional notice requirements in the subcontract, such as the second seven-day notice required by the AIA A401 form. The subcontractor should be directed to protect its work and to demobilize from the site by a specific date.

**DOCUMENTING THE DEFAULT**
Even if the general contractor has absolutely clear grounds to terminate a subcontractor for default, the general contractor should “document” the circumstances thoroughly so that, if necessary, it can prove the grounds for default to an arbitrator, judge or jury -- often many months or even years later. As a practical matter, the project manager or superintendent may not be available to testify at the time of the trial or arbitration hearing. Even if available, their testimony alone regarding the subcontractor’s poor performance will not carry much weight if it is not backed up with documents and other evidence recorded at the time of the events -- not after the subcontractor has been terminated.

Correspondence, meeting minutes, schedules, daily construction reports, photographs, videotape and similar “contemporaneous” evidence documenting the subcontractor’s poor performance and the condition and status of the subcontractor’s work and the project as a whole at the time of the termination are critical to proving that adequate grounds existed for termination. The general contractor should also attempt to obtain letters from the owner or architect directing the general contractor to remove the subcontractor, describing the problems that the subcontractor is causing to the project, or, at a minimum, consenting to the termination and replacement subcontractor.

**MITIGATING DAMAGES AND DOCUMENTING THE COMPLETION WORK**
After terminating a subcontractor, the general contractor should take steps to “mitigate” or minimize any additional costs or damages. For example, the general contractor should make sure that the work has been protected until a replacement subcontractor is on site.
If feasible, the general contractor should also solicit bids from several qualified subcontractors before contracting for the work to make sure that a competitive price is obtained. Where possible, the work should be procured on a fixed-price rather than time-and-material basis to avoid an argument by the terminated subcontractor that the replacement contractor was, in effect, given a “blank check”. The bid solicitation process should be documented, and the scope of work should be well-defined.

Finally, the general contractor should require the replacement subcontractor to provide detailed applications for payment, broken down by line item and supported by appropriate backup documentation. If the work can be procured only on a time-and-material basis, it is especially important that the replacement subcontractor maintain detailed backup documentation, including payroll records, equipment and material invoices, and daily construction reports describing the work completed.

**CONSEQUENCES OF IMPROPER TERMINATION**

The consequences of improperly terminating a subcontractor can be severe. If the general contractor improperly terminates the subcontractor, the subcontractor may have a claim against the general contractor for lost profits plus any additional damages caused by the improper termination, such as amounts owed by the subcontractor to lower tier subcontractors and suppliers. The general contractor would also lose the right to recover from the terminated subcontractor amounts paid to a replacement subcontractor hired to complete the work. In other words, a general contractor that improperly terminates a subcontractor may end up paying at least twice for the remaining work.

On the other hand, if the general contractor gives proper notice of the default and can prove that it had adequate grounds to terminate the subcontractor, the general contractor’s exposure to the subcontractor generally will be limited to the total subcontract amount minus the expense of finishing the subcontractor’s work and other damages incurred by the general contractor.