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Building Knowledge

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Editor's Note

BY SAMUEL H. LEVINE

One of the most difficult decisions a general contractor has to make on a project is whether to terminate a subcontractor on a project, whether for "cause" or for "convenience." There is the impact of termination on the balance of the project and damages which may be due to the subcontractor. Ehren Fournier and Margery Newman present a primer on contract damages resulting from termination. Ehren (faegredrinker.com) is an associate with Faegre Drinker Biddle & Reath LLP where he handles construction and eminent domain related matters. Margery (Mnewman@dl-firm.com) is a partner with Downey & Lenkov LLC. Margery concentrates her practice in construction law, including construction law in both the private and public sectors.

Mark Gryzmala writes about perfecting and enforcing lien and bond claims against

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Construction Whack-a-Mole: Termination for Cause, Termination for Convenience, and Actions for Breach of Contract

BY EHREN FOURNIER & MARGERY NEWMAN

Your $200 million, class-A, commercial office building construction project is six weeks behind because your steel subcontractor can't pass inspection. The steel contractor blames the architect and engineer of record for providing a non-compliant design. It's not clear that the steel subcontractor defaulted under its subcontract, but the general contractor believes the best way forward is to cut ties with the steel subcontractor and replace it to get the project on track and prevent any further delay on claims from other trades. The general sends a notice of default and, after the cure period expires,

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Editor's Note

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Illinois public construction projects. Mark (mark@gryzmalalaw.com) is the president and founder of Gryzmala Law Offices, P.C. where he practices in commercial litigation and construction law.

Take a look at *American Steel Fabricators v. K&K Iron Works,* 2022 IL App (1st) 220181, where the first district held that a subcontractor has authority to serve a section 34 demand on a secondary subcontractor. ■

Construction Whack-a-Mole: Termination for Cause, Termination for Convenience, and Actions for Breach of Contract

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terminates the contract for cause. The subcontractor sues the general for breach of the subcontract and, through the course of the dispute, the court determines that the subcontractor did not breach and the general was wrong to terminate for cause, awarding the subcontractor the full contract price. "But wait," says the general, "there's a clause in the subcontract that lets me convert a termination for cause into a termination for convenience if a court finds that my termination for cause was wrong. Now I only owe the subcontractor the damages called for in the termination for convenience." The subcontractor disagrees—the general contractor should not get a second bite at the apple just because it misfired on the basis for termination. Who wins?

Contract Damages

At the risk of insulting the readers of this article with first-year contract law principles, a basic primer on various aspects of damages in a breach of contract action helps to understand the impact of various termination clauses. The fundamental premise of contract damages says that a non-breaching party should receive the benefit of its bargain, or expectation damages. Parties can also recover the natural and probable consequences of the breach, such as lost profits, materials costs, overhead, opportunity costs, etc.—the "consequential" and "incidental" damages resulting from breach.

That said, the law gives great freedom for parties to fashion their own remedies. Accordingly, parties often draft contracts that exclude consequential and incidental damages. Parties also rely on liquidated damages clauses to simplify the calculation of damages in situations where the parties cannot easily calculate the amount that will make the aggrieved party whole.

This brings us to the concept of efficient breach, a widely held theory in contract law among law and economics scholars and jurists. According to the theory of efficient breach, a party can "justifiably[1]" breach a contract if the expectation damages paid by the breaching party are less than the breaching party's costs of full performance and the non-breaching party will be no worse off economically than if the breaching party fully performed. For example, A contracts with B to paint A's house for $100. C approaches B and offers to pay B $300 to paint C's house, which would require equal time and effort as painting A's house. B cannot accept both jobs. B earns an extra $200 by breaching its contract with A, paying A the $100 back, and accepting a contract with C for $300.

Termination for Convenience Clauses vs. Termination for Default Clauses

Looking at the above example, what if A's contract with B contained a clause that allowed B to terminate the contract, but only pay A a fraction of the total contract price? That is the effect of a termination for convenience clause. The use of termination for convenience clauses has a history dating back to federal contracts during the Civil

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War.[2] The federal government relied on termination for convenience clauses during World Wars I and II, the goal being to prevent costly consequences of terminating wartime contracts in the unfortunate event peace broke out.[3]

AIA General Conditions document A201-2017 § 14.4 provides an example of a termination for convenience clause, stating that the owner may terminate the contract "for the Owner's convenience and without cause." In such a case, the owner must pay the contractor the following: "Work, properly executed; costs incurred by reason of the termination, including costs attributable to termination of Subcontracts; and the termination fee, if any, set forth in the Agreement."[4]

Conversely, termination for cause requires a default by the other party that justifies the non-defaulting party's termination of the contract. Again, flashing back to first-year contract law, not every breach of contract justifies the non-breaching party's termination of the contract. A termination for cause provision expressly states the criteria allowing the non-breaching party to terminate. For example, the AIA general conditions allow the owner to terminate the contractor in the event contractor does any of the following:

§ 14.2.1 The Owner may terminate the Contract if the Contractor

.1 repeatedly refuses or fails to supply enough properly skilled workers or proper materials;

.2 fails to make payment to Subcontractors or suppliers in accordance with the respective agreements between the Contractor and the Subcontractors or Suppliers;

.3 repeatedly disregards applicable laws, statutes, ordinances, codes, rules and regulations, or lawful orders of a public authority; or

.4 otherwise is guilty of substantial breach of a provision of the Contract Documents[5]

In the event the owner terminates the contractor for cause, "Contractor shall not be entitled to receive further payment until the Work is finished."[6] Under the AIA documents, if the unpaid balance of the total contract price to the contractor upon conclusion of the work exceeds the costs for finishing the work, the owner pays the excess of the contract price over the cost of completing the work to the contractor. If the owner's damages and costs exceed the contract price, the contractor shall pay the difference to the owner.[7]

Changing Rationales

A new hypothetical: A contracts with B to have B construct a commercial office building. In the middle of the project, A terminates B for cause and stops payment. B threatens to sue for the amount A owes, claiming A wrongfully terminated B. The contract contains a "conversion clause" which specifically addresses when and under what circumstances a party may change the basis of termination from "for cause" to "for convenience." A invokes the conversion clause and states that it now has terminated B for convenience and that B is not entitled to the full amount due under the contract. B sues for breach. How does the court handle it?

In the presence of a conversion clause, courts will generally look to whether the terminating party changed its rationale for terminating the contract in bad faith.[8] For example, in the case of *Accent Builders Co. v. S.W. Concrete Sys, Inc.*, the general contractor terminated the contract for convenience.[9] The subcontractor brought a trial for breach of contract and, as a defense, the general contractor asserted it terminated for cause.[10] In remanding the case back to the trial court, the Court of Appeals instructed the trial court to determine whether the general contractor changed its position in bad faith or whether the subcontractor acted in reliance on the general contractor's change of position.[11] In a later case, the Court of Appeals of Texas reiterated that a "general contractor is not bound by its first announced reason for terminating a subcontract absent bad faith by the general contractor or a change of position in reliance by the subcontractor."[12] There, the Court of Appeals found no bad faith when a general contractor complied with the terms of the termination for convenience provision, despite raising the convenience issue for the first time at trial after having stated to the subcontractor that it was terminating the contract for cause.[13] The Appellate Court of Illinois upheld a similar clause in *Christopher Glass & Aluminum, Inc. v. Tishman Constr. Corp. of Ill.*[14] In relying on Texas courts interpreting similar clauses, the Appellate Court held that a conversion clause would be meaningless if courts refused to enforce it in the face of a wrongful termination.[15]

There are also instances where the termination-for-cause provision contains a clause wherein in the event a court or other body determines that the for-cause termination was improper, the contract automatically deems the termination for convenience.[16] In *Pinckney*, the postmaster terminated a contract mail carrier for cause after she allegedly failed to deliver mail to certain addresses.[17] In the absence of any bad faith on the part of the government, the Court of Claims converted the termination for cause to a termination for convenience, and awarded the contractor liquidated damages in accordance with the termination-for-convenience provision of the contract.[18]

However, in the case of *Rogerson Aircraft Corp. v. Fairchild Industries, Inc*.,[19] the court prevented the terminating party from changing its rationale after stating it was terminating its supplier for cause. There, Fairchild terminated its contract with Rogerson to supply certain ductwork and equipment for Fairchild's protype engine de-icing system because Fairchild had both changed its design and found another supplier with more favorable terms.[20] However, Fairchild told Rogerson it had terminated the contract due to Rogerson's default. When Rogerson sued Fairchild for breach of contract, Fairchild changed the basis of termination, instead relying on the termination for convenience provision. The court disagreed with Fairchild and held that Fairchild could not avoid damages for wrongful termination by reversing course and saying that it should have terminated for convenience.[21] The court in *Rogerson* never expressly addressed whether Fairchild initially terminated for default in bad faith, which would seem to suggest that any post-hoc change in termination rationale would fail in California.

How does one square *Rogerson* with the cases where courts allowed a post-hoc change of basis for termination? First,

courts appear much more accepting of a post-hoc change of rationale when a party converts from a termination for convenience to a termination for cause. Courts are less clear as to whether the door swings in the opposite direction. Second, Fairchild's initial termination for default in *Rogerson* was clearly a pretext to avoid paying Rogerson and to a better deal from another provider. Fairchild's bad faith in terminating Rogerson for a more favorable contract was so obvious that the court did not need to expressly address it. Consequently, courts seem to be motivated by the terminating party's bad faith. A court's refusal to enforce a conversion clause based on the objective bad faith of the terminating party also allows courts to avoid rendering such clauses null by ignoring their plain language.

What constitutes bad faith? In *Keeter Trading Co. v. United States*,[22] another case involving the termination of a postal contractor, the Court of Claims summarized bad faith as "evidence of improper motive on the part of the government" in terminating the contract.[23] The court reviewed whether the government's actions: (1) were motivated by some animus toward the contractor; (2) sought to injure or do harm to the contractor; (3) were designed to force the removal of the contractor; and (4) sought to frustrate the performance of the contractor.[24]

The Restatement (Second) of Contracts provides additional guidance. A party seeking to terminate a contract by alleging a breach or default by the other party should carefully review its own conduct in terminating.[25] Bad faith in the enforcement of a contract (*i.e.*, in deciding whether to demand performance or terminate) can be found in conduct such as "conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts."[26] It also may include taking advantage of the other party's circumstances to change the terms of the contract, harassing demands for performance, rejection of the other party's performance for unstated reasons, failing to mitigate damages, and abusing its discretion to determine compliance or terminating the contract.[27]

To conclude, the essential lessons for any party who wants to take advantage of a conversion clause to minimize the potential damages in a contract dispute include: (1) be sure to read the language of the clause carefully to understand the circumstances under which a party can change rationale for termination; (2) avoid the appearance of a pretextual termination; (3) avoid harassing demands for complete performance; and (4) avoid rejecting the other party's performance or terminating the contract for hypertechnical or superficial reasons. ■

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1. Understandably, readers who believe a commercial contract evidences a promise with moral weight (the "promise theory" of contract law) would disagree with the authors' characterization that a party can ever justify breaking a promise.
2. Deborah S. Ballata & Marlo Cohen, *Termination for Cause or Convenience: What Happens if You are Wrong?* 13 No. AC-CLJ 4 (2019).
3. *Id.*
4. AIA A201-2017 § 14.4.3.
5. *Id.* at §§ 14.2.1.1-4
6. *Id.* at § 14.2.3.
7. *Id.* at § 14.2.4.
8. Ballata, *supra* note 2.
9. 679 S.W.2d 106, 108 (Tex. App. 1984).
10. *Id.* at 108-109.
11. *Id.* at 110.
12. *Roof Sys., Inc. v. Johns Manville Corp.*, 130 S.W.3d 430, 443-44 (Tex. App. 2004).
13. *Id.*
14. 2020 IL App (1st) 191972-U (Ill. App. Sept. 30, 2020).
15. *Id.* ¶ 99.
16. See, *e.g.*, *Pinckney v. United States*, 88 Fed. Cl. 490, 504 (2009).
17. *Id.* at 490-503.
18. *Id.* at 514-16.
19. 632 F. Supp. 1494 (C.D. Cal. 1986).
20. *Id.* at 1497.
21. *Id.* at 1499.
22. 79 Fed. Cl. 243 (2007).
23. *Id.* at 263.
24. *Id.* at 263-64.
25. Restatement (Second) of Contracts § 205 (1981).
26. *Id.* cmt. e.
27. *Id.*

How to Perfect and Enforce Your Lien and Bond Claim Against Illinois Public Construction Projects

BY MARK B. GRZYMALA

Introduction

In this article, will look at the steps that need to be taken in order to perfect and enforce a lien claim against Illinois public projects such as municipal buildings, public schools, city parks or Illinois roads.

'Perfecting' Your Illinois Mechanics Public Lien Claim

General Contractors

With respect to public projects, general contractors (those who contract directly with the public entity/owner) generally do not have lien rights. Because public liens are liens against funds and not against real estate, they must recover any the balance due from the owner.

Subcontractors and Material Suppliers

If you are a subcontractor working on a public project and are unpaid, you are then entitled to assert a lien claim against the funds that the public entity is holding. This right is granted pursuant to section 23 of the Illinois Mechanics Lien Act. This type of lien claim is often referred to as a "trapping lien" and traps any funds that are left to be paid for the project. A subcontractor asserts or perfects its lien claim against the funds by serving a notice of claim.

A subcontractor's notice of claim for lien against public funds must:

1. Be written and verified.
2. Identify the name and address of the subcontractor asserting the claim.
3. Identify the subcontractor's contract and the project the work is performed.
4. Identity the general contractor and any upper tier contractors.
5. Describe the work the subcontractor performed.
6. State the balance due the subcontractor.

The notice of claim must be served upon the general contractor and the clerk or secretary of the local public entity (or director if a state agency) via registered or certified mail with return receipt requested. The notice can also be served by personal delivery and is good upon acceptance by the public entity.

There is no statutory deadline to assert such a lien claim, however, once the general contractor is paid there will be no more funds left to assert a lien against. It is important to assert your rights as soon as you suspect difficulty in receiving payment.

Once the notice of claim is served, it can be enforced.

Enforcing your Illinois Public Mechanics Lien Claim

In order to enforce a claim for lien against public funds, a subcontractor must file a lawsuit for an accounting and to enforce its lien claim within 90 days of serving the notice of claim. The lawsuit is filed in the county where the project is and must include all parties in the chain of contract between you and the owner. The public entity does not need to be named unless you are seeking action against it or alleging some type of wrongdoing *(e.g.*, you are seeking interest under the Illinois Local Government Prompt Payment Act)

In the lawsuit, you will be asking the court to order to pay the public entity the balance due in addition to interest and attorneys' fees incurred as provided by the Illinois Mechanics Lien Act. The lawsuit can also contain other causes of action such as breach of contract against the owner or general contractor, fraud, actions for bounced or NSF checks, account stated, and anything else related to the contract or project. The complaint can also and should include an action to enforce your bond claim as explained below.

Please note that whether or not the subcontractor names the public entity, the clerk or secretary of the public entity must always be served with a copy of the filed complaint within 10 days after filing.

If the lawsuit is not filed within 90 days, the subcontractor will lose its lien rights.

Enforcing your Illinois Bond Claim

The Illinois Public Construction Bond Act (30 ILCS 550/1 *et seq.*) requires that for any public project over $50,000.00 a general contractor provide bonds that guarantee performance of the contract by the general contractor and payment to the subcontractors. This law is often referred to as a "Little Miller Act" in reference to the federal law governing bond requirements on projects owned by the federal government or its agencies.

In order to assert a claim against a payment bond against an Illinois or local project, the subcontractor or material supplier needs to prepare and send a notice of claim.

A subcontractor's notice of claim against payment bond is very similar to a notice of claim against public funds and must:

1. Be written and verified.
2. Identify the name and address of the subcontractor asserting the claim.
3. Identify the subcontractor's contract and the public project the work is performed.
4. Identity the general contractor and any upper tier contractors.
5. Describe the work the

subcontractor performed.
6. State the balance due the subcontractor.
7. Although not required, the notice should state the name of surety and bond number if known.

The notice of claim against payment bond must be served upon the local public entity via registered or certified mail with return receipt requested or by personal delivery and a copy to the general contractor within 10 days of service. However, it is good practice just to send the notice out at the same time to everyone, including the surety if known. The claim is good upon acceptance by the public entity and can be enforced immediately.

In order to enforce a claim against payment bond, a subcontractor must file a lawsuit to enforce its lien claim within 1 year of its last date of furnishing. The lawsuit is brought on behalf of the public entity for the use and benefit of the subcontractor and against the surety. The lawsuit is filed in the county where the project is.

If the lawsuit is not filed within 1 year of the last furnishing date, the subcontractor will lose its bond rights.

Combining Notices and Lawsuits

Given that the requirements for clams against public funds and payment bond are so similar, is it common and good practice to combine both notices of claims against public funds and payment bond into one document and serve that. A subcontractor can then commence one lawsuit and enforce both claims, as well as any other claims it may have against its customer in the same action.

Bankruptcy – Lien and Bond Claims

What happens if your customer, the general contractor, the owner, or any other interested party file for bankruptcy?

As in the case of a lien against a private project – bankruptcy stays enforcement of a lien or bond claim but not perfection.

Once a party files for bankruptcy protection, the automatic stay applies and the debtor is protected from any collection attempts by creditors. Creditors cannot commence or continue any litigation against the debtor. However, the stay DOES NOT prohibit a party from asserting or perfecting its Illinois mechanics lien and bond rights. A contractor who is not paid should still serve its notice of claim in order to trap any funds that are left due the general contractor.

The automatic stay does, however, prevent enforcement of the lien claim. A subcontractor first needs to file a motion in the bankruptcy court and seek modification of or relief from the automatic stay so that it can enforce its lien claim. The bankruptcy courts often allow this request as long as the contractor does not seek money damages from the bankrupt debtor. Once the bankruptcy court grants the motion to modify or lift the automatic stay, the contractor can then proceed to file a lawsuit to enforce the lien against the public funds.

With respect to bond claims, a subcontractor can still assert a claim and file suit to enforce a bond claim even if its customer is bankrupt. Only bankruptcy of the surety would stay any such action.

Lien and Bond Claim Deadline Summary

Here is a summary of the deadlines that subcontractors need to adhere to in order perfect and enforce their lien and bond rights against public projects. These are the most important to remember.

Subcontractor – Lien Claim

- Serve notice of claim Against Public Funds once payment issues are suspected
- File a lawsuit to enforce lien within 90 days of serving the notice of claim of the last date of furnishing.
- Serve a copy of the lawsuit to the Clerk or Secretary of the public entity

Subcontractors – Bond Claim

- Serve notice of claim within 180 days of the last date of furnishing.
- File suit to enforce the bond claim within 1 year of the last date of furnishing.

Both the notice of claim Against Public Funds and notice of claim Against Payment Bond can be combined into one document. One lawsuit can be filed to enforce both claims and it is much more efficient and cost effective to do so.

The deadlines must be followed exactly and the lien claim and bond claim notices must contain all of the necessary information described above in order to perfect and enforce your rights. However, it is always best to consult an attorney if you suspect you are having payment issues and need to protect your lien and bond rights.■