CHAPTER 7

Default and Termination

BUYER IN DEFAULT

Opportunity

Having a customer in default is a problem. Like most problems, however, a default also brings opportunities. The customer may be pleading with you for additional time or other accommodations. When the customer needs you for something, you may have leverage to request something from the customer. You have an opportunity to become more aggressive with the customer and others on the project. Do *not* forget to take advantage of this opportunity. It may determine whether or not you collect.

Additional Information

At a minimum, you can and must demand missing information on the project and the customer. Demand hard information and documents. Determine if the project is bonded and demand a copy of that bond. Demand accurate descriptions of the project property and allocation information, so you know the value of your labor or materials incorporated into each parcel of property. Demand information on project funding and correct names and addresses for the owner, architect, lender and general contractor. Demand information on your customer, including the names of all partners involved and complete financial statements. It is now time to get complete credit applications with updated information and all of the protective terms and conditions discussed above.[1]

These demands serve two purposes. First, you need more information to preserve your rights. Second, you begin to flush out your real problems. You should be very wary of the debtor who refuses to provide any information. Providing information does not cost a debtor anything. If the debtor wants to avoid interference in their project, they must give you some other adequate security. The debtor that will give you nothing at this point is the debtor who *intends* never to give you anything. This is a sure sign that you now need to move aggressively to enforce legal rights.

Consensual Security

Don't forget that you have an additional opportunity to request security when your customer is in default. Tell the customer that you will accommodate him so long as the customer accommodates you with some security arrangement. If you are asked for additional time, tell the customer that you don't mind waiting so long as you know that you will be paid eventually. Providing consensual security is *not* a problem for a debtor, as long as they pay you. If they are unwilling to provide you personal guaranties, an assignment of accounts receivable or some other security interest, *this is the most accurate indication that they doubt their ability to pay*.

Take debtors at their word. It is the surest way to know who is sincere. If they are certain you will be paid "Wednesday when the general contractor pays," there should not be any problem assigning you that account receivable or contacting the general contractor to confirm the payment—and perhaps request a joint check. If a debtor retreats at these suggestions, you are receiving an important indication that he is not telling you the truth.

A detailed discussion of various consensual security agreements appears in other chapters of this book.[2] Sample language for a Joint Check Agreement, Security Agreement and a simple Assignment of an accounts receivable is available in the Appendices.

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[1] *See* chapter, Credit Management; subsection, Credit Applications. *See also* chapter, Contract Terms and Preserving Rights; subsection, Supplier Credit Applications and Proposals.

[2] *See* chapters, Contract Terms and Preserving Rights and UCC Security Agreements; section, Contractor and Supplier Contract Forms; subsections, Guaranties and Joint Check Agreements.

Getting the Worm

The early bird gets the worm. This is the most important rule to remember about collecting accounts in default. When they begin to get in financial trouble, most debtors have some cash flow, which they can divert as they wish. Debtors will prioritize their debts and address what they feel it is most important.

It is your objective at this point to be your debtor's highest priority. You want to be the one creditor that your customer feels they must accommodate now. Moving fast doesn't necessarily mean filing suit immediately. It does mean that you should be in constant contact with the debtor. Make the most of your opportunity to improve your position. Withhold additional performance. Demand additional security. If the debtor refuses to accommodate you in a satisfactory manner, then move promptly to enforce your legal rights. If they are unwilling to accommodate you with adequate assurances, this is your surest sign that they doubt their ability to ever pay and want to make sure that you are a general unsecured creditor later.

If you must enforce your legal rights, you have a much greater chance of success if it is done early. Quick action is normally necessary to preserve judicial security rights, including mechanic's liens and payment bonds.[3] The first creditor to file suit usually has the greatest chance of applying pressure while the debtor still has some cash flow to divert. Make it easier and cheaper to pay you than to ignore you. In short, the creditors that hit early and forcefully will get paid; the creditors that wait out of patience or ignorance will end up as general unsecured creditors with unenforceable judgments against bankrupt debtors.

Getting Ahead

It is your objective to be preferred over all other creditors. It is the defaulting debtor's objective to stall you as much as possible to keep you from getting the worm. Accordingly, you must carefully scrutinize anything that is "offered" to you by a debtor in default. They have a great incentive to "give" you nothing. If you are not careful, you will get nothing but a lot of conversation and give up important rights in the bargain.

In any agreement with a debtor in default, you want to make sure you are getting ahead. Make sure that after the agreement you are somehow better off than you were before the agreement. This sounds obvious, but it is surprising how many creditors will enter into agreements that do not help them and may actually hurt them.

If a debtor is 60 days past due, they may "offer" to pay you next Wednesday with funds they expect to receive, so long as you agree not to lien the project today. This is an agreement that will leave you worse off. You already had one agreement with the debtor to pay you 60 days ago. Now you will replace that with an agreement to pay you in the future instead, and you have given up a valuable legal right in exchange. Also, the debtor has already failed to keep one agreement he had to pay you 60 days ago. What makes you think he will keep an agreement to pay you next week? You are worse off after making this second agreement.

It is good news that your debtor expects a check on Wednesday and intends to pay you. Just make sure you do not agree to anything in exchange for payment. Just say, "That is good to know" and "I will look forward to receiving the check Wednesday." Meanwhile, keep moving to improve your legal position.

Promissory Notes

The most common example of agreements that do not help are promissory notes. Promissory notes are nothing more than a contract in which a debtor agrees to pay you at some future date. You probably already have a contract in which the debtor has agreed to pay you for materials within 30 days of delivery. How does it help to exchange this for a contract to pay you sometime later? Even if you do not have a written contract, you have a legally enforceable right to payment from the debtor on completion of your work or delivery of materials.[4] If you have a written contract, you hopefully also have provisions for attorney's fees and service charges, so even this part of a promissory note usually doesn't add anything.

Promissory notes can be good things to have, for reasons discussed immediately below. Forms for promissory notes and confessed judgment promissory notes are shown in the Appendices. Just make sure you do not give up legal rights in exchange for the note unless the note is adding something just as important. It is almost never a good idea to give up mechanic's lien or payment bond rights in exchange for a promissory note and rarely a good idea to

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[3] *See* chapters, Mechanic's Liens in Virginia, Mechanic's Liens in Maryland, Mechanic's Liens in Pennsylvania, Mechanic's Liens in the District of Columbia, and Performance and Payment Bonds.

[4] *See* chapter, The Uniform Commercial Code Sale of Goods; section, Contract Interpretation; sub-subsection, Time for Payment. *See also* chapter, Contract Terms and Preserving Rights; section, Contractor and Supplier Contract Forms; sub-subsection, Draw Schedule.

wait for very long. If you agree to wait several months for a payment on a note, for example, you will probably just end up as a general unsecured creditor of an insolvent debtor. You will not get the worm.

It is important to state that the note "is provided not in payment of, but as additional security for ... obligations due to seller under existing credit agreements." With this statement, you are *adding* legal rights against the debtor, in addition to any rights you have under a credit agreement or mechanic's lien statute. Without this statement, the debtor can argue that your debt has been "paid" with the promissory note and that you no longer have mechanic's lien or other legal rights.

A seller should assume that the debtor will not be willing or able to perform any new promise in the future and make sure that the seller can feel that it nonetheless accomplished something positive with the promissory note. It is normally a good idea to insist on the first payment with the signed promissory note. If that first payment exceeded the costs of preparing the promissory note, the seller is ahead. The promissory note can be a vehicle to add an attorney's fees provision, a forum selection clause or some other terms, if the seller does not already have an adequate credit agreement. A promissory note can also be a vehicle to add a personal guarantee, at least on the old debt, if the current debtor is a limited liability entity. A promissory note is also an opportunity to liquidate the account.

Guaranties and Joint Check Agreements

Getting a general personal guarantee on the account can be an important opportunity on default.[5] A material seller may even be willing to supply additional materials if a debtor will supply a personal guaranty or a consensual security interest. This can be a "win-win," in which both the debtor and creditor benefit. This can be done in the Guaranty or in the Promissory Note in the Appendices. A joint check agreement can be a similar mutually beneficial arrangement, although the agreement of the debtor's debtor (owner or general contractor) will be necessary.[6] This arrangement can be beneficial to the owner or general contractor, however, in order to keep the project going.

Liquidating the Account

If a customer is in default on payment, it is very important to "liquidate the account" at an early opportunity. This simply means that the customer acknowledges the amount of its debt to you in writing. This can be done in the form of a Promissory Note shown in the Appendices.

If a customer is requesting extra time to pay, it is often easier to require a letter acknowledging the amount of the debt and establishing that payment will be made on a certain date in the future. It is often better for you to prepare such a letter and send it to the customer to initial and return. This letter can consist of a single sentence but must acknowledge the amount of money owed and the fact that it is now due.

Liquidating the account can save you much time and money later. A customer may verbally promise you payment over and over again, stringing you along for months. Once you begin legal action, however, you will hear for the first time of all the problems the customer had with your services or materials. Customers in financial trouble will become desperate, doing anything to buy additional time. If the account has been liquidated, however, you may save a lot of time and money defending against frivolous back charges. You may also be able to obtain "Summary Judgment," a judgment obtained much faster and less expensively than a judgment obtained through a full trial.

As mentioned above, liquidating the account can be done through promissory notes. A good promissory note also can add significant legal rights. You may be able to improve your situation in a promissory note by adding a new debtor or adding individual signatures instead of a corporate signature. Perhaps you can add a spouse, making your debt more collectable. The debtor may agree to an interest rate above the legal rate or may agree to an attorney's fee provision that does not exist in your contract.

Application of Payments

Once your debtor is in default, your ability to apply payments received from the debtor becomes very important. The general rule is that you may apply payments as you see fit, unless the customer has instructed you otherwise.[7] The debtor does have the power to instruct you as to how payments are to be applied, and you are bound by such

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[5] *See* chapter, Contract Terms and Preserving Rights; section, Contractor and Supplier Contract Forms; sub-subsection, Guaranties.

[6] *See* chapter, Contract Terms and Preserving Rights; section, Contractor and Supplier Contract Forms; sub-subsection, Joint Check Agreements.

[7] *Northern Virginia Savings & Loan Assoc. v. Kendall*, 205 Va. 136, 135 S.E.2d 178 (1964); *See also United States for the Use and Benefit of Maddox Supply Company v. St. Paul Fire and Marine Insurance Company*, 86 F.3d 332 (4th Cir. 1996).

instructions. Also, if you know that the customer has obtained funds from a particular source, you may be required to apply the payment to that account.

You may want a contract term with your customer allowing you to apply all payments as you see fit. Once a customer is in default, you may require such an agreement before you agree to delay legal action or agree to continue shipping. The Credit Application in the Appendices contains such general application of payments language. Take note, however, that this language is as yet untested in the courts.

For construction suppliers supplying multiple projects for a customer, only some of the projects may have mechanic's lien or payment bond rights. The seller wants the ability to apply payments received to all other projects before applying payment to the project with the best mechanic's lien or payment bond rights. It is also more efficient to seek one large payment for one project than payment on several smaller accounts receivables for scattered projects. This will give you a single owner to deal with in the case of negotiated direct payment. This will also give you only one set of facts and one lawsuit in the case of mechanic's lien or bond rights, instead of multiple lawsuits. Finally, it will greatly reduce the time spent by your attorney and the fees you incur. An organized debtor will usually supply "advice" on any check sent, instructing you to apply the payment to particular invoices. However, a debtor in default may send you a five thousand dollar ($5,000) "good faith" payment without advice how to apply it. This is an opportunity to improve your position.

Carefully inspect any check received for language to the effect that it is "full and final payment" or that "acceptance of this check constitutes a waiver of any further claim." In some states, you may be able to strike this wording out. In most states and under the Uniform Commercial Code, however, you will be in danger of waiving any further claim by depositing such a check. The debtor will claim an "accord and satisfaction."

Collecting Information on Default

If your project has slipped into the 60-day column, you should begin working feverishly to collect the information on the sample Project Information Sheet in the Appendices. This information is critical in the preparation of an accurate lien or bond claim and can sometimes take a long period of time for your attorney to collect. You will also substantially hold down costs by doing much of this footwork yourself.

Internal information should be collected and kept in a separate "collection" file as soon as the credit manager is aware that the account has become a problem. The credit manager should collect signed delivery tickets, bills of lading, time cards and similar documents. The credit manager should keep the original documents, or at least copies, in a separate file. Some of these documents will not be needed for months or even years later in a court proceeding, making it difficult (or even impossible) to assemble them at a future date. It is also a good idea to interview witnesses at an early stage to see what they remember. Record statements from witnesses and develop outline chronologies. This will make it much easier for these witnesses to recall events months later. This will also help if a witness becomes unavailable at a later time.

If an account is past due 60 days, you should be taking some legal action now. No one likes to incur legal fees unnecessarily, but waiting until the last minute adds unnecessary pressure, which will result in mistakes. Mechanic's lien and bond laws are an extremely technical area.

On default, the account should become the exclusive responsibility of a manager to closely monitor. You should consider having your attorney begin a title search on the property or obtain a copy of any payment bond at this point. This is a relatively inexpensive step but requires the greatest amount of lead-time. You should also consult your records and discuss the case with your attorney at this point to establish with certainty your deadlines. Once you have established your deadlines and have the preliminary title search or other work ready, you can usually wait until the last two weeks before the deadline to begin preparation of the actual mechanic's lien or bond claim notice.

Right to Adequate Assurance of Performance

A material seller has the right to demand "adequate assurance of due performance" from the buyer.[8] A material buyer has the right to expect that goods will be delivered. A material seller has the right to expect payment for the materials. When reasonable grounds for "insecurity" arise, a party may demand in writing an "adequate assurance of due performance."[9] If a seller, for example, has reasonable grounds to believe that the buyer will be unable to make payment, that seller could demand an assurance that the buyer is capable of paying, before goods are delivered. The

[8] UCC Section 2-609(1).

[9] UCC Section 2-609(1).

Official Comment to the UCC states that a seller has reasonable grounds for insecurity if a buyer falls behind in his account with the seller, even though the items involved have to do with separate and legally distinct contracts.[10] On the other hand, a buyer who requires precision parts has reasonable grounds for insecurity if he discovers the seller is making defective deliveries of such parts to other buyers.[11]

Preserving Mechanic's Lien and Payment Bond Rights

Don't let your security rights expire. This is the number one rule once a default has occurred. Have all the conversations you want but do not let your judicial security rights expire *unless the debtor can provide you with something at least as good*. Very few things will be better than judicial security to assure future payment. Unless the debtor has a very strong financial statement or can provide a strong guarantor, you will probably have to demand a consensual security interest in some other property before you agree to give up mechanic's lien or payment bond rights.

Defense of Payment

Money flows down the payment chain from the lender to the owner to the general contractor to the subcontractor to the supplier. As a practical matter, one of the most important bits of information to collect on default is "who has the money" within this payment chain. If your debtor received the money 90 days ago and is now 60 days past due, you are in serious trouble. If the money is still held by someone up the payment chain and you can contact them, you will normally be in better shape. You may have the practical ability to "jam-up" the money to keep it away from the debtor. This may also be important to preserve security rights, as discussed below. You also have an opportunity to solve your problem without "hurting" anyone.

If an upstream contractor has not yet paid your debtor, they are indifferent as to whether they give the money to you or give it to the debtor. They are still paying only once. The debtor will have to admit that you are entitled to the money. It is very difficult for a debtor in this position to justify refusing a joint check agreement. Once the money has flowed down to your debtor, however, the owner and any upstream contractors are faced with paying twice for the same labor and materials. This they will not want to do. Whether or not the mechanic's lien law in this state has a technical "defense of payment," anyone will fight paying the same debt twice. This is why it is so important as a practical matter to know where the money is and to "get in the way" before it flows downstream.

In some states, the validity of your mechanic's lien will depend on the status of accounts between your debtor and the contractors further upstream. Mechanic's lien statutes in Virginia and the District of Columbia, for example, have a "defense of payment." The owner or general contractor is required to pay for the project only once. If the owner or general contractor can show they have paid in full, they have a "defense of payment." You may not have mechanic's lien rights even though your debtor has squandered the money intended for your materials. This may give you a deadline for mechanic's lien filing that will come up more quickly than 90 days. You must get notice of your mechanic's lien to the owner before payments "flow downstream" to your debtor. This is discussed in greater length in the mechanic's lien sections of this book.[12]

It may be important to collect information on the status of payments and to make upstream contractors aware that you have not been paid, even before you intend to file a mechanic's lien. You may wish to use a formal or informal notice to "freeze" payments upstream. You could send the owner a "Notice of Intent to Lien" or just a letter. These mechanisms may have no legal effect but will normally cause upstream contractors to stop making payments. This may preserve your mechanic's lien rights and should provide at least some practical assistance.

Contacting upstream contractors may make it unnecessary to later file a lien or make a bond claim. If you make upstream contractors aware that you are on the project, they are likely to make sure you get paid in order to avoid mechanic's lien or bond claims. If you have not already done so, this is also an opportunity to determine whether you are a true general contractor, subcontractor or sub-subcontractor. Such a distinction will help you and your lawyer determine whether you have lien or bond rights in this situation.

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[10] UCC Section 2-609, Official Comment 3.

[11] UCC Section 2-609, Official Comment 3.

[12] *See* chapters, Mechanic's Liens in Virginia, Mechanic's Liens in Maryland, Mechanic's Liens in Pennsylvania and Mechanic's Liens in the District of Columbia.

Assignment of Payment Bond or Mechanic's Lien Rights

A financially weak debtor may not have enough money or sophistication to enforce their mechanic's lien, payment bond, or even their contract rights. If a seller is doing business in a state with mechanic's lien remoteness issues, such as the District of Columbia[13] or Pennsylvania,[14] a seller may not have mechanic's lien rights, even though the customer does. There is a temptation to "solve" this problem by having the debtor "assign" its mechanic's lien rights to the seller.

The most obvious problem is that an assignment of the debtor's mechanic's lien rights will not solve a "defense of payment" problem. The debtor does not have mechanic's lien rights if the debtor is not owed any money on the project. If the debtor was paid or the debtor defaulted on its contract, any seller with an assignment of mechanic's lien rights has no enforceable rights on the project. Also if the debtor's customer on the project has been paid, any seller with an assignment of mechanic's lien rights has no enforceable rights on the project.

An assignment of mechanic's lien rights could solve remoteness issues, by bringing the seller one tier closer to the owner and general contractor. In Virginia and Maryland, for example, mechanic's lien rights are assignable. However, in many states, a seller cannot be confident. The law on this question varies from state to state. There has been no attempt here to research the answer in all fifty states. However, there is simply no answer in many states, including Pennsylvania[15], because the question has never come up in a recorded case. This sometimes makes it impossible to be completely confident how a court would view an assignment of mechanic's lien rights.

Legal rights are generally assignable and this does allow a general prediction that mechanic's lien rights are also assignable.[16] However, some states prohibit the assignment of mechanic's lien rights on public policy grounds. The state legislature has granted mechanic's lien rights to certain classes of labor and material suppliers.[17] The limitations of these rights cannot be circumvented by private contract. The mechanic's lien rights are "personal" to the claimant that supplied labor or material.[18]

In some states, the assignability of mechanic's lien rights depends on whether the labor or material has already been supplied, so that the mechanic's lien rights already exist at the time of assignment. In other states, the assignability of mechanic's lien rights depends on whether the mechanic's lien has already been perfected (filed) at the time of assignment.[19] In some states, there is clear case law that mechanic's lien rights are assignable, but sometimes this case law is quite old and may have been based on an older version of the statute.[20] In some states, you will have some certainty that mechanic's lien are assignable. In other states, you will have some certainty they are not. In many states, you just will not know for sure.

Federal Miller Act bond rights do have some certainty on assignability. The case law seems fairly clear that federal Miller Act bond rights are assignable.[21] This federal law should be applicable to federal projects in all fifty states.

Many states have Little Miller Acts that are very similar to the federal Miller Act. However, the assignability of Little Miller Act bond rights will be state specific. State courts tend to look to the federal Miller Act to interpret their state Little Miller Act, unless the state law has a relevant difference in wording. However a state court is not bound to follow federal Miller Act case law and this will create uncertainty, unless a high ranking court has ruled on the

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[13] *See* chapter, Mechanic's Liens in the District of Columbia; section, Remote Subcontractor and Suppliers Liens.

[14] *See* chapter, Mechanic's Liens in Pennsylvania; section, Remote Subcontractor and Suppliers Liens.

[15] *But see Hartman v. Keown*, 101 Pa. 338, (1882) [valid assignment of a lien on a mare on the sale of the debt].

[16] *Davis v. Bilsland, 85 U.S. 659 (1873*) [Based on Montana mechanic's lien statute, U.S. Supreme Court ruled that mechanic's liens are assignable. Claimant had "completed his claim by filing his lien before assigning it to the plaintiff. It was perfectly lawful for him to assign his claim. It was not against any principle of public policy to do so"].

[17] *Gould, Inc. v. Dynalectric Company*, 435 A.2d 730 (Sup.Ct. Del 1981).

[18] *Georgia-Pacific Corp. v. First Wis. Fin. Corp.,* 625 F. Supp. 108, 116 n.4 (N.D. Ill. 1985).

[19] *Talco Capital Corp. v. State Underground Parking Comm'n*, 324 N.E.2d 762, 767 (Ohio Ct. App. 1974); *Gould, Inc. v. Dynalectric Company*, 435 A.2d 730 (Sup.Ct. Del 1981).

[20] *Bristol Iron & Steel Co. v. Thomas*, 93 Va. 396, 397 (1896) [As a general rule, any contractual right is assignable, and the assignment carries with it all liens given for its security. An assignee was entitled to perfect the inchoate lien which existed for the benefit of his assignor]; *Iaege v. Bossieux*, 56 Va. 83 (1859) [There is nothing in public policy or in the language or the policy of our act to forbid it; and if the statute be exclusively for the benefit of the builder and material-man it would certainly impair the value of his lien to declare it non-assignable]; *Nat'l Elec. Indus. Fund v. Bethlehem Steel Corp.,* 296 Md. 541, 552 (1983) [A Union could enforce the mechanic's lien rights of subcontractor-employees for the purposes of collecting Union fees]; *See also District Heights Apartments v. Noland Co*., 202 Md. 43, 46 (1952) [The subcontractor, having encountered financial difficulties, had assigned all its right, title and interest in the money which the general contractor owed it. However, the dispute in this case addressed only delivery and notice issues. Apparently, the assignment was not directly addressed or contested].

[21] *U.S. ex rel. Sherman v. Carter, 353 U.S. 210, 219 (1957).*

issue in a recorded case. There is no known case law of this subject in the Mid-Atlantic states. Accordingly, you can make a general prediction that state Little Miller Act bond rights are assignable. However, you do not have certainty unless there is clear high level state case law that Little Miller Act bond rights are assignable.[22]

Private bond rights would not have the same public policy questions. A bond is a private contract. Contract rights are generally assignable. Accordingly, you can make a general prediction that private bond rights are assignable. However, the answer to this question will be state specific. There seems to be little case law on this subject and no known case law in the Mid-Atlantic states. You do not have certainty. Since a private bond is a private contract, there are also no restrictions how the bond form is worded. Any owner and general contractor would be free to agree in the bond that rights would be nonassignable. This would further complicate the issue.

In summary, the assignability of mechanic's lien or bond rights will be very state specific, except for federal bonds. For credit management planning purposes, an assignment of mechanic's lien or bond rights will always be helpful, but may not be an entirely dependable solution. A seller may need to have another mechanism to have confidence.

However, a creditor that has already supplied labor or material and has a debtor in default is in a very different posture. It is often a good strategy to get an agreement that the creditor can enforce the debtor's mechanic's lien or bond rights in the debtor's name. The debtor can agree that the creditor's law firm can bring the action in the debtor's name, that the creditor has the right to decide how or when to settle the case and that the creditor receives all proceeds until paid in full. As a practical matter, the opposing parties may never know that it is the creditor enforcing these rights and may never raise assignability questions. It is also arguable that this is not an assignment at all. Any "assignment" of mechanic's lien or bond rights should be worded this way for this reason, whether negotiated before or after the supply of labor or material.

Notices of Non-Payment Default

Should a contractor contact the owner or construction lender when they are not being paid? This frequent and tough question is a double-edged sword.

Such contacts will often freeze payments. This can help preserve mechanic's lien rights, as discussed immediately above. On the other hand, if payments are frozen no one will get paid. It is usually better to preserve security than to be sorry later. If the contractor works his way up the payment chain, explaining to each party his concern and the need to preserve rights, the political damage can often be controlled.

Owners need to be sensitive to a contractor's need to preserve security. It is often a good idea for owners and banks to structure payments to go directly to subcontractors by the agreement of all parties via joint check or using another arrangement. Although owners and banks may often feel that they "don't want to get involved," this attitude will often lead to mechanic's liens on the project and more disruption.

Any contractor that contacts parties up the payment chain needs to be very careful about interfering with contractual relations and defamation. In many states, it is defamatory *per se* to make statements that would prejudice a person in his or her profession or to imply an inability to pay debts when they become due.[23] However, truth is an absolute defense to a defamation action. You can say that a debtor is past due in payments to you if absolutely sure this is true.

It is also wise to make objective statements about past facts, such as "I have filed a lien" or "I have not been paid for 90 days." Avoid subjective statements like "He is a liar and a cheat." Such subjective statements are less effective than objective statements of fact and can only hurt you in actions for defamation or tortious interference with contract. It is also important to avoid statements concerning actions you are going to take in the future. Such statements have antitrust implications as part of a possible joint boycott or "black listing." It is appropriate to make the statement, "I stopped deliveries to that debtor last week." This is an objective statement of past fact. Never tell another creditor, "I am going to stop deliveries to that debtor next week."

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[22] *Quantum Corporate Funding, Ltd. v. Westway Indus.*, 4 N.Y.3d 211 (N.Y. 2005); *Trs. for Mich. Laborers' Health Care Fund v. Seaboard Sur. Co.,* 137 F.3d 427 (6th Cir. 1998); *Shoshoni Lumber Co. v. Fidelity & Deposit Co.*, 46 Wyo. 241 (Wyo. 1933); *Finch v. Enke*, 54 S.D. 164 (S.D. 1929).

[23] *See* Va. Code Anno. §8.01-45 (Michie 1950), for example.

The Right to Stop Work for Non-Payment

In the absence of specific contract language, the right to stop work for nonpayment is a troublesome issue.[24] Sellers constantly ask whether they have to return to the project and complete work even though their debtor is in default on payment. The answer usually is yes; the seller must return.

The Law

Courts have stated in some cases that the seller has the right to suspend work or terminate the contract and sue for damages for non-payment.[25] The party who commits the first *material* breach of a contract is not entitled to enforce it.[26] However, if the breach did not go to the "root of the contract" but only to a minor part, the contract is still enforceable.[27] Only if the initial breach is material, is the other party to the contract is excused from performing its contractual obligations.[28]

The Realities

A seller is not relieved of his obligations unless the debtor has "repudiated" the contract or "materially and substantially" breached the contract so as to defeat the object of the parties in making the contract. Receiving payment is certainly the objective of the seller when he signed the contract. However, it is hard to tell exactly how long is too long to wait for payment or exactly how much non-payment is too much.

If the debtor disputes 5% of the requisition and delays the entire payment for two weeks as a result, this may not relieve the seller of his performance. If the seller has suspended work and refuses to return to the job, the seller may himself be in breach.[29] When this situation escalates into multiple breaches by both sides, where the debtor refuses to pay and the seller refuses to work, it becomes very difficult to determine who is guilty of the initial breach or who breached the contract the most.

By the time such a case reaches court, the debtor will be able to show multiple breaches by the seller both before and after the initial non-payment. This is partly because the modern construction project is very complex and neither side is completely performing all contract requirements. It may also be because the debtor has good lawyers who can make any seller look bad or at least confuse what the seller views as a clear situation.

If a seller has materially breached their contract themselves, then withholding a payment may be justified. Refusing to perform further work on the projects would then be a second breach of contract by the seller. The seller will be liable for damages from all breach of contract, while the buyer is liable for no breach of contract and no damages.[30]

A fairly constant problem with construction projects is the "disproportionality" of damages. Even if the buyer is certainly in breach of contract by withholding payment, the buyer is liable in damages equal to the time value of money. This means the seller would get interest for the delay in payment. If it turns out that the seller was guilty of the first breach, however, the damages for delaying a project will be huge. There is usually a large downside risk to stopping work for any supplier of labor or material on a construction project.

As a practical matter, a seller should continue to perform to its utmost ability until the debtor has *repeatedly* failed to pay; the seller has made multiple requests and has continually requested reasons for non-payment; and the seller has resolved any outstanding problems or items identified by the debtor as needing correction.

Contractual Right to Stop Work

Many of these problems can be avoided through careful contracting. A seller in a strong bargaining position can obtain a contract term stating simply that the seller may suspend work if payment is not received *for any reason* until the issues causing non-payment are resolved. Standard AIA documents and many other contracts provide a seller

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[24] *See* AIA Document A401-2017 (Standard Form of Agreement between Contractor and Subcontractor), Section 4.8.

[25] *Pickens County v. National Surety Co*., 13 F.2d 758, 761-762 (4th Cir. S.C. 1926); *Shapiro Engineering Corp. v. Francis O. Day Co*., 215 Md. 373, 137 A.2d 695 (Md. 1958); *Fromm Sales Co. v. Troy Sunshade Co*., 222 Md. 229, 159 A.2d 860 (Md. 1960); *Burras v. Canal Construction and Design Co.*, 470 N.E.2d 1362 (Ind. App. 1984); *See also United States v. Safeco Ins. Co. of America*, 555 F.2nd 535 (5th Cir. 1977); *S.W. Rodgers Co. v. Aztec Constr. Co.*, 1997 Va. Cir. LEXIS 690, 19 Cir. L155591 (Fairfax County 1997).

[26] *Federal Ins. Co. v. Starr Electric Co*., 242 Va. 459, 468 (Va. 1991), *citing Hurley v. Bennett*, 163 Va. 241, 253, 176 S.E. 171, 175 (1934).

[27] *Countryside Orthopedics v. Peyton*, 261 Va. 142, 154, 541 S.E.2d 279 (2001).

[28] *Pickens County v. National Surety Co*., 13 F.2d 758, 761-762 (4th Cir. S.C. 1926); *Shen Valley Masonary v. S. P. Cahill & Assocs.,* 57 Va. Cir. 189, 198 (Va. Cir. Ct. 2001), *citing Horton v. Horton*, 254 Va. 111, 115, 487 S.E.2d 200 (1997).

[29] *K & G Constr. Co. v. Harris*, 223 Md. 305, 164 A.2d 451 (Md. 1960).

[30] *K & G Constr. Co. v. Harris*, 223 Md. 305, 164 A.2d 451 (Md. 1960).

with the right to suspend work for non-payment and eventually terminate upon notice.[31] This type of contract clause is helpful but will not eliminate the practical problems discussed above.

SELLER IN DEFAULT

Contract Termination Clauses

Just as sellers often wish to stop performance on non-payment, owners or general contractors often wish to terminate a contractor they consider to be in default. This contractor usually must be allowed to return to the job, however, unless the contract allows for "termination for default." There is no absolute right to terminate a contract, even for default, unless the contract so provides.

Modern construction contracts contain language concerning termination. In this case, it is very important to analyze the definition of default and provide proper notice. If the rules of the contract are followed, a rightful termination will exist. If not, a wrongful termination has occurred. The difference is very important in determining which party is liable for damages and in what amount.

A contractor is not in default whenever the owner is unhappy or the job is not going as planned. A contractor is not in default just because his work is ugly or is taking longer than expected. The contract itself will define default in any specific case, and this document must be examined to determine whether a default has occurred. Owners and contractors will often ignore their own contracts when declaring a default.

Many a letter has been sent and received declaring a contractor to be "in default" when no legal default actually existed. Most commonly, a contractor receives a letter stating it is in default for "delaying the project." An examination of the contract will often show that there is no schedule for the work in the contract and/or there is no term in the contract stating that delay is a default.

Many contracts define default as a failure to perform an obligation after written notice has been received. This is the "notice and opportunity to cure" provision discussed earlier.[32] Under this language, no "default" exists until the notice has been received and the obligation remains unperformed.

The terms of a contract will be strictly construed against the party who wrote it.[33] If the owner drafted and provided the contract without a default for delay clause, he will be held to it.

A person contracting for work wants to make sure that anything that has the potential to hurt him—anything he does not like or anything that just makes him nervous—will be defined as a default of the contract. An owner or a general contractor wants to be the one to make the determination, in his sole discretion, that a default has occurred. The types of action that an owner or general contractor wants to define as a default are:

1. Failure to provide sufficient, properly skilled workmen or materials of proper quality
2. Failure, in any respect, to prosecute the work according to the current schedule as established from time to time
3. Causation of a stoppage, delay or interference of the work of any other contractor
4. Failure to comply with any provision of the contract or the contract documents
5. Experiencing financial difficulties including bankruptcy, insolvency or failure to pay subcontractors or materialmen on time
6. Violating local law, ordinance or safety regulations in any way.

Notice and Avoiding Termination

The single most important default provision for a contractor is "notice and an opportunity to cure."[34] It is important to remember this at the contract negotiation stage.

[31] *See* AIA Document A401-2017 (Standard Form of Agreement between Contractor and Subcontractor), Section 4.8; American Institute of Architects (AIA) Document A201-2017 (General Conditions of the Contract for Construction) Section 14.1.1. *See also* chapter, Contract Terms and Preserving Rights; section, Contractor and Supplier Contract Forms; subsections, Supplier Credit Applications and Proposals and Reviewing and Revising Contracts Received; sub-subsection, The Right to Stop Work.

[32] *See* chapter, Contract Terms and Preserving Rights; section, Reviewing and Revising Contracts Received; subsection, Notice and Opportunity to Cure.

[33] *Winn v. Aleda Construction Co.*, 227 Va. 304, 315 S.E.2d 193 (1984).

[34] *See* AIA Document A401-2017 (Standard Form of Agreement between Contractor and Subcontractor), Section 7.2.1; *See* chapter, Contract Terms and Preserving Rights; section, Reviewing and Revising Contracts Received: subsection, Notice and Opportunity to Cure.

Providing notice of default is generally not harmful to an owner who truly desires to complete the project as planned. As a practical matter, the owner will almost always want to put a contractor on notice of default in order to compel performance. Many owners and contractors would prefer, however, to provide notice at their discretion rather than as a requirement of the contract.

If a contract calls for notice and an opportunity to cure, both are necessary for an effective termination. Both owners and contractors should be aware of contract terms to this effect. If the owner does not follow his own procedure, the termination may be deemed "wrongful." If a contractor is not aware of the contract provisions, he may wake up one morning to find himself terminated.

Avoiding Termination without Notice

Without the extra notice and cure time, the contractor may not be able to get back on the site to document the extent to which the work is already completed, to photograph the alleged defects or to cure the default. Also, given an opportunity, a contractor can often show an owner that

1. The dispute is a misunderstanding, easily curable or not actually a "default" as defined in the contract;
2. Delay was caused by changed conditions that would entitle the contractor to a change order or an extension of time;
3. The alleged defect or problem was the result of defects in the plans and specifications;
4. Performance is impossible because, for example, certain materials are no longer available;[35]
5. Termination is a bad option for the owner. The job will most likely be delayed, and any new contractor coming in will likely charge a premium that may or may not be collectible against the original contractor. Also, the owner will have the burden of proof in any future proceeding to show rightful termination. If this burden is not met, then the owner will be liable for damages;
6. Substantial completion of the project has taken place. A contractor can rarely be terminated, even for default if substantial completion has occurred. In fact, terminating a contractor while he is in punch list is sometimes an area of abuse by owners; and[36]
7. As a practical matter most contractors will get at least one strike or maybe two or three before they are out. If a contractor has notice, it is usually productive to contact the owner, display an intention to complete the contract and show that the alleged breach can be cured (or that it is not a breach at all).

Anticipatory Breach, Repudiation or Material Breach

In the absence of clear contractual provisions for default, notice and termination, it is very difficult to determine when a contract has been breached to the point that it is terminated and the other party is relieved of any further obligation. Even with specific contract provisions, a court may be reluctant to hang a contractor that has made a good faith effort to perform. It is important, therefore, to understand whether an anticipatory breach, a repudiation or a complete material breach has occurred.

Material Breach: Going to the Essence of the Contract

Even without default provisions in the contract, a contract can sometimes be breached so completely that the non-breaching party is relieved of any further obligation. This does not happen often, however, and it is very difficult to know when there has been a "sufficient" breach. In most modern construction contracts, both parties usually are not following every technical term of the contract. They are always "in default." In such a situation, the other party is *not* relieved of its obligations. If the party refuses to perform, then both sides are in default. Although both sides are liable for damages to the other, the contract is not terminated.[37]

If the breach is material and goes to the "essence" of the contract, so that one party's contract objective is destroyed, then the other party will be relieved of any further obligation.[38]

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[35] *Ballu v. Basic Construction Company*, 407 F.2d 1137 (4th Cir. 1969).

[36] *Worthington Corp. v. Consolidated Aluminum Corp.*, 544 F.2d 227 (5th Cir. 1976).

[37] *Horton v. Horton*, 254Va. 111,487 S.E.2d 200 (1997); *Mansfield v. Honorable Verne Orr, Secretary of the Air Force*, 545F.Supp. 118 (D.Md. 1982).

[38] *Hurley v. Bennett*, 163 Va. 241, 253; 176 S.E. 171, 175 (1934).

Payment is the "essence" or the "objective" of the contract to a contractor. If an owner fails to pay without reason, then the contractor is relieved of any further obligation.[39] As a practical matter, however, an owner can usually identify defaults or problems that are grounds for withholding payment. If the contractor then refuses to perform, he takes the risk of being in default. If the owner later shows that the contractor had previously defaulted, the contractor will be liable for damages.[40]

Anticipatory Breach, Renunciation or Repudiation

When can you be so sure that the other party will be unable to meet its obligations in the future that you can treat it as a breach of contract now? Declaring an anticipatory breach of contract cannot be based on a partial breach or on a breach that is not of such substantial character as to defeat the object of the party to the contract.[41] In short, there must be a distinct, unequivocal and absolute refusal on the part of one of the contracting parties to perform his part of the contract.[42]

Renunciation and repudiation are similar concepts; one party to a contract notifies the other that it will proceed no further in performing the contract. A renunciation and repudiation can be retracted as long as the non-breaching party has not yet acted upon it.[43] When an anticipatory breach, renunciation or repudiation has occurred, the non-breaching party is relieved of any further obligation and may elect to sue at once without waiting for the time of performance to arrive.[44]

Rightful Termination

If the contractor has been rightfully terminated, the contractor has no claim against the owner for damages. Under a properly drafted contract, the terminated contractor may be liable for the costs of completion after termination and other damages.[45]

Wrongful Termination

By terminating a contractor, the owner runs a considerable risk that the termination will be found "wrongful." This is a primary reason why owners want to provide contractors an opportunity to cure any default. An owner who has wrongfully terminated can be liable for requisitions and retention that should have been paid, expenses for idle labor and unused materials, and lost profit for labor and material actually supplied on the project.[46] An owner that has wrongfully terminated a contract may not be able to recover for the costs of completing or correcting work[47] and may be liable for lost profit on the terminated portion of the contract.[48]

Another possible penalty to the owner for wrongful termination is that the contractor can sue the owner for unjust enrichment. If the owner has received a benefit from the contractor's services and refuses to pay for that benefit, then he has been unjustly enriched by the value of those services. The contractor may sue to recover the value of his services (*quantum meruit*) and the value of the materials he provided (*quantum valebat*). The value of the contractor's work may be greater than the contract price if the bid was low.

Both the owner and the contractor should make every effort to document the progress of the work upon termination, whether the termination is rightful or wrongful. Photographs are the easiest and most important part of this, along with a scheduling analysis. The contractor and owner should also create detailed estimates of the cost to complete

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[39] *See* AIA Document A201-2017 (General Conditions of the Contract for Construction), Section 9.7; AIA Document A401-2017 (Standard Form of Agreement between Contractor and Subcontractor), Section 7.1.

[40] *See* section above, Buyer in Default; subsection, The right to Stop Work for Non-payment; sub-subsection The Law and The Realities.

[41] *City of Fairfax v. Washington Metropolitan Area Transit Authority*, 582 F.2d 1321 (4th Cir. 1978), cert. denied, 440 U.S. 914, 99 S.Ct. 1229, 59 L.Ed.2d 463 (1979).

[42] *Mutual Reserve Fund Life Ass'n v. Taylor*, 99 Va. 208, 37 S.E.2d 854 (1901).

[43] *Vahabzadeh v. Mooney*, 241 Va. 47, 399 S.E.2d 803 (1991).

[44] *Roberts v. Coal Processing Corp.*, 235 Va. 556, 369 S.E.2d 188 (1988); *Simpson v. Scott*, 189 Va. 392, 53 S.E.2d 21 (1949).

[45] *See* AIA Document A401-1987 (Standard Form of Agreement between Contractor and Subcontractor), Section 7.2.1.

[46] *ADC Fairways Corp. v. Johnmark Construction, Inc*., 231 Va. 312, 343 S.E.2d 90 (1986)*; Spotsylvania County v. Seaboard Surety Co.,* 243 Va. 202, 415 S.E.2d 120 (1992).

[47] *ADC Fairways Corp. v. Johnmark Construction, Inc*., 231 Va. 312, 343 S.E.2d 90 (1986); *Spotsylvania County v. Seaboard Surety Co.,* 243 Va. 202, 415 S.E.2d 120 (1992); *Bell BCI Co. v. HRGM Corp*., 2004 U.S. Dist. LEXIS 15305 (D. Md. Aug. 6, 2004); owner did recover for costs of correcting work in *Smither & Co. v. Calvin-Humphrey*, 232 F.Supp. 204 (D.C.D.C. 1964).

[48] *ADC Fairways Corp. v. Johnmark Construction, Inc*., 231 Va. 312, 343 S.E.2d 90 (1986) [inadequate evidence for lost profit claim]; *Smither & Co. v. Calvin-Humphrey*, 232 F.Supp. 204 (D.C.D.C. 1964) [inadequate evidence for lost profit claim].

the work, and each may want to hire an independent expert to view the project at an early stage. This can be very important for each side in the event of litigation.

After termination, the most common issues of disagreement are back charges and the cost of completing the work. Contractors rarely understand how an owner could have spent so much money to complete a project. And, unfortunately, some owners abuse the situation by building a Taj Mahal at the expense of the contractor.

Termination for Convenience

The termination for convenience clause is the owner's best weapon against a claim for wrongful termination. This clause was originally created by federal agencies and appeared only in government contracts. It has become more popular, however, in private contracts.

Termination for convenience means exactly that: The owner can terminate a contractor for any reason when it is in the owner's best interest. Most clauses state that the contractor will be entitled to compensation for work done prior to termination together with earned profit. Most contracts also state that if any termination for default turns out to be wrongful, then it will automatically be deemed a termination for convenience.[49] If this happens, the owner may be financially responsible for work completed and earned profit but will not be liable for other consequential damages or unearned profit.

There are limits to the right to terminate for convenience, primarily the implied duty to exercise the right of termination in good faith and in accordance with fair dealing. This is true even for public owners,[50] but probably even more true for private owners.[51] For example, an owner cannot terminate a contractor just because the owner is able to get a better price elsewhere.

Warranty Claims

If there is no written contract defining the warranties in a construction contract, the common law (court case law) would imply a warranty that the work should be done in a reasonably good and workmanlike manner.[52]

Most modern construction contracts have written "warranties." For example, AIA Document A107-1997 states:

> **§ 17.2** ... if, within one year after the date of Substantial Completion of the Work or designated portion thereof or after the date for commencement of warranties ... any of the Work is found to be not in accordance with the requirements of the Contract Documents, the Contractor shall correct it promptly after receipt of written notice from the Owner to do so unless the Owner has previously given the Contractor a written acceptance of such condition. The Owner shall give such notice promptly after discovery of the condition. During the one-year period for correction of Work, if the Owner fails to notify the Contractor and give the Contractor an opportunity to make the correction, the Owner waives the rights to require correction by the Contractor and to make a claim for breach of warranty.

Note that this warranty provision speaks in terms of a one-year obligation. However, it is a mistake for a contractor to believe that they only have a one-year obligation to correct defective work. The "statute of limitations" for breach of a written contract is five (5) years in Virginia and three (3) years in Maryland. The statute of limitations is the maximum period of time to file a lawsuit for breach of contract. If an owner can prove that labor or material was

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[49] *Bell BCI Co. v. HRGM Corp*., 2004 U.S. Dist. LEXIS 15305 (D. Md. Aug. 6, 2004).

[50] *Krygoski Constr. Co. v. United States*, 94 F.3d 1537, 1541 (Fed. Cir. 1996) [The Government's authority to invoke a termination for convenience has, nonetheless, retained limits. A contracting officer may not terminate for convenience in bad faith, for example, simply to acquire a better bargain from another source, *citing Torncello v. United States*, 681 F.2d 756, 772 (Ct. Cl. 1982) [When tainted by bad faith or an abuse of contracting discretion, a termination for convenience causes a contract breach],*citing Allied Materials & Equip. Co. v. United States*, 215 Ct. Cl. 902, 905-06 (1977)].

[51] *Questar Builders, Inc. v. CB Flooring, LLC*, 410 Md. 241, 272-73, 978 A.2d 651 (2009) [private parties do not have the near carte-blanche power to terminate for convenience that the federal government has, but limited to exercising that discretion in good faith and in accordance with fair dealing. Party with discretion is limited to exercising that discretion in good faith and in accordance with fair dealing. Upon entering a binding contract for a specified duration, the parties thereto give up their opportunity to shop around for a better price].

[52] *Mann v. Clowser,* 190 Va. 887, 901, 59 S.E.2d 78 (1950) [Ordinarily a person undertaking a particular work impliedly agrees to exercise a degree of skill equal to the undertaking. If a person holds himself out as specially qualified to perform particular work, there is an implied warranty that the work shall be of proper workmanship and reasonable fitness for its intended use. "In building and construction contracts it is implied that the building shall be erected in a reasonably good and workmanlike manner and when completed shall be reasonably fit for the intended purpose"], *citing* 17 C.J.S., Contracts, sec. 329, p. 781, note 53.

defective and was a breach of the contract at the time it was installed, the owner would have this five or three-year period of time to file suit for the costs of corrective work.

Parties to a private contract can agree to shorten the statute of limitations for a breach of the contract. However, a one-year warranty provision like the one above does not shorten the statute of limitations. It would be necessary to specifically state that the "statute of limitations will be one year." In fact, there is a good chance that the one-year warranty provision lengthens by one year the time to file suit. A breach of the warranty provision could occur if a contractor failed to correct work one year after completion and then the owner would have the five or three-year statute of limitations time period after that to file suit.

The difference between a breach of contract claim and a breach of warranty claim is not clear in a labor and material contract. It would seem that any breach of warranty would be a breach of contract. Perhaps a breach of warranty is a type of "no fault" claim. The contractor agrees for one year to correct any work "not in accordance with the requirements of the Contract Documents." Perhaps an owner does not need to prove that the nonconforming work was the fault of the contractor for this one-year period, but must prove a breach of the contract by the contractor after one year.

The Uniform Commercial Code, a part of most state codes, defines a breach of warranty in the sale of construction materials,[53] although those UCC warranties can be modified by a purchase order or other contract to warranties similar to those in a labor and material contract.

Back Charge Damages

As discussed above, the owner runs a considerable risk in terminating a contractor. If the owner breaches the contract by "wrongfully" terminating a contractor, the owner has committed the "first breach" and may not be able to enforce the contract against the contractor to get costs of completion or correction. Wrongful termination most often occurs by an owner who simply does not read the contract provisions and fails to follow the termination procedure.

When a subcontractor does fail to keep his agreement, however, the measure of damages will normally be the amount necessary to put the non-breaching party in as good a position as if the contract had been performed. The non-breaching party must prove their damages with reasonable certainty, but not with mathematical certainty. The non-breaching party is required only to enable the court to make an intelligent and probable estimate of the damages sustained.[54]

The contract will often dictate or modify the costs that can be charged against the defaulting subcontractor. Owners and general contractors are also often guilty of not reading these contract provisions and seeking unallowable back charges. If a contract says only that the breaching contractor will "be responsible for all of the *costs*" of the defect, then "costs" do include profit on the corrective work and may not include overhead either. Similarly, there is much argument whether in house supervisors and laborers are a cost at all, whether their regular hourly rate would be a "cost," or only their direct payroll. An owner or general contractor can solve these problems with contract terms stating that a defaulting subcontractor is responsible for all out of pockets costs, supervisors and laborers at their regular hourly rates, plus 20% overhead and profit.

An owner or general contractor will have the "burden of proof" to prove their damages against a defaulting subcontractor. If they fail to put on sufficient proof, they will lose in a court of law, even if it is clear that the subcontractor did default. Of course, the burden of proof is really only relevant in a court trial. In negotiations, a debtor owner or general contractor has a tremendous advantage against a creditor subcontractor or supplier. The debtor has possession of all the labor and material and possession of all the money. The creditor is often forced to make considerable accommodation in negotiating the exact amount of back charges, because of this leverage.

Scheduling and delays, liquidated damages, no damage for delay clauses and waiver of consequential damages are discussed in the chapter on Changes, Delays and Other Claims.[55]

Direct and Consequential Damages

The types of damage incurred in a contract action include "direct" and "indirect" damages. Direct damages are those which arise "naturally" or "ordinarily" from a breach of contract. They are damages that can be expected to

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[53] *See* chapter, The Uniform Commercial Code Sale of Goods; section, Contract Interpretation; subsection, Warranties.

[54] *Nichols Constr. Corp. v. Va. Mach. Tool Co., LLC*, 276 Va. 81,89, 661 S.E.2d 467, 472 (2008).

[55] *See* chapter, Changes, Delays and Other Claims; section, Contract Clauses and Theories.

result from a breach in the ordinary course of human experience. "Indirect" damages, also called "consequential" damages arise from the intervention of "special circumstances" not ordinarily predictable.

If damages are direct, they are compensable. If damages are consequential, they are compensable only if it is determined that the special circumstances were within the "contemplation" of both contracting parties or were "predictable." Whether damages are direct or consequential is a question of law. Whether special circumstances were within the contemplation of the parties is a question of fact.[56]

It is often difficult to determine whether damages are direct or consequential. Court case law is sometimes conflicting and confusing. Commonly identified examples of consequential damage, however, would be lost profits or lost opportunities to pursue other business, where no contract yet exists. It is possible to waive the right to consequential damages in a contract.[57]

Cost or Value Measure of Damages

There are sometimes arguments whether the proper measure of damages for defective construction is the cost to rectify the work or the reduction in value of the building with the defects. If some imbedded construction material did not comply with the contract, the cost to rectify the work can be huge compared to the minor reduction in value of the building because of the nonconforming work. The owner is entitled to the cost of correction, unless that cost "is grossly and unfairly out of proportion to the good to be attained." When that is true, the measure is the difference in value.[58]

These two methods of determining monetary damages in breach of construction contract cases are called the "cost rule" which is the cost of correcting the defects in the construction and making it conform to the terms of the contract and the "value rule" which is "the difference between the value of the structure properly completed according to the contract and the value of the defective structure. The cost of correction or completion rather than loss in property value is normally the proper basis for measuring the damages, especially where correction or completion would not involve unreasonable destruction of work done by the contractor and the cost would not be grossly disproportionate to the results to be obtained.[59]

[56] *Roanoke Hosp. Ass'n v. Doyle & Russell, Inc.,* 215 Va. 796, 214 S.E.2d 155 (1975), *citing 5 A. Corbin, Contracts* §1012(89) (1964); *C. McCormick, Damages* §140 (574) (1935) [Interest carrying costs are direct damages due to delay, but an increase in interest rates are indirect consequential damages not contemplated by the parties].

[57] *See* chapter, Changes, Delays and Other Claims; section, Contract Clauses and Theories; subsection, Waiver of Consequential Damages.

[58] *Mann v. Clowser*, 190 Va. 887, 904-905, 59 S.E.2d 78 (1950), *citing* Judge Cardozo in *Jacob v. Kent*, 230 N.Y. 239, 656, 129 N.E. 889, 130 N.E. 933, 23 A.L.R. 1429.

[59] *Nichols Constr. Corp. v. Va. Mach. Tool Co., LLC*, 276 Va. 81, 89-90, 661 S.E.2d 467 (2008); *see also Mann v. Clowser*, 190 Va. 887, 904-905, 59 S.E.2d 78 (1950)[For defective or unfinished construction, the non-defaulting owner or general contractor is entitled to either:
(i) the reasonable cost of construction and completion in accordance with the contract, if this is possible and does not involve unreasonable economic waste; or
(ii) the difference between the value that the product contracted for would have had and the value of the performance that has been received by the plaintiff, if construction and completion in accordance with the contract would involve unreasonable economic waste].