Avoiding "Intentional Breach" of Construction Contracts

Why it matters ...

By Robert J. Kaler, Esq

Most contractors are aware of the importance of avoiding so-called "material" breaches of their contracts—i.e., breaches that are significant enough to give the other party to the contract the right to sue the contractor and recover damages for the breach. But there is another kind of breach that it is equally important for the contractor to avoid, and that is the so-called "intentional" breach—i.e., one which may not be significant enough to be deemed material, and may or may not affect the quality of the construction, but is committed by the contractor with deliberate intent, and voluntarily, with full knowledge that it is a breach of the contract.

PROMPT PAYMENT PROVISION

Usually an intentional breach is committed because it will benefit the contractor in some way and because the contractor assumes that the breach will cause no serious loss to the owner, or damage to the construction. One good example of such an intentional breach is a contractor's deliberate decision to "stretch out" payments to its subcontractors on a project where its contract with the owner requires it to timely pay those subcontractors in accordance with the terms of their subcontracts—i.e. a so-called "prompt payment" provision—and to certify with each of its requisitions to the owner that it is doing so.

Suppose, for example, that the chief financial officer of a contractor working on dozens of multi-year, multimillion dollar construction projects, with hundreds of subcontractors and suppliers, begins to realize that if he or she waits as little as 10 or 20 extra days to pay those subcontractors and suppliers the amounts that are due them, the company can save tens of thousands of dollars in borrowing costs on its credit lines, and keep its cash balances high at its quarter and year ends—thereby making its quarterly and financial statements look better. And, suppose the CFO implements that policy across the board, informing all project managers that this is company policy going forward.

Suppose further that a good number of those contracts have prompt payment provisions, and prompt payment certification requirements—as many state and federally funded projects do – and that the project managers working for the contractor on those projects are aware of those requirements, but have no authority to force the contractor CFO to make the payments to the subcontractors in a timely fashion. So they complain about it internally, but go ahead and sign the certifications that subcontractors are being timely paid, when they know they are not, and assume that since the owner is not losing any money, and the quality of the construction is theoretically not being compromised, it is a "no harm no foul" situation.

ABOUT THE AUTHOR

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PRESCRIPTION FOR DISASTER

Under the law of many jurisdictions, this is a prescription for disaster, because in many jurisdictions, the law of contracts includes a centuries old common-law rule sometimes referred to as the "intentional breach doctrine." Under this doctrine, as applied in the construction context, a contractor cannot recover any monies owed to it under its contract, whether pursuant to claims for extra work or retainage, if it has "intentionally" breached that contract, even if the breach is not material, and has not caused an out-of-pocket loss to the owner. The rationale for this rule, in the jurisdictions where it is applied, is simple: (i) contracts are "promises that the law will enforce," (ii) the law's willingness to enforce the contract is dependent upon the party seeking to enforce it having acted in "good faith," and (iii) an intentional departure from contract requirements is not consistent with good faith, and therefore will bar recovery under the contract (unless the intentional breach is so extremely minor as to be *de minimus*).

Returning to our above example, suppose at the end of one of the contractor's many projects it claims it is owed millions of dollars of retainage that the owner has withheld, and wants to present tens of millions of dollars in claims for extra work that it claims it performed, or delays that it claims it suffered. If the contractor is in a jurisdiction that applies the "intentional breach doctrine," it can be barred from doing either. This is because its intentional failure to timely pay subcontractors and suppliers—in order to avoid borrowing money for operations and keep one's own cash balances high—and its false certifications to the owner that it was timely paying its subcontractors and suppliers when in fact it was not were obvious intentional breaches of its contract, and were not consistent with that jurisdiction's "good faith" conduct requirement.

AVOID INTENTIONAL BREACH

Increasingly, modern construction contracts contain provisions like this intended to ensure that more is accomplished under the contract than just design and/or construction of the facility in question. Often the goal of the project is to inject monies into the economy of the geographic area where the project is to be performed—hence the more frequent "prompt payment" and "small business participation" requirements of modern public contracts. Other similar goals may be to promote the development of minority- or women-owned businesses, or to promote the purchase of American-made materials (i.e., "buy America" provisions). Whatever the motivation for these and other provisions, in many jurisdictions the contractor intentionally breaches them at its peril, and the lesson is to know the law on this issue in the jurisdictions in which you contract, and provide a mechanism whereby the application of company-wide policies can be adjusted where necessary in order to avoid intentional breach of one's construction contracts. ■