

*A Practical Guide to the
Termination of Contracts*

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**A Practical Guide to the
Termination of Contracts**

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Topics

- How a right to terminate arises:
 - at common law; and
 - under a contract.
- How to exercise a right to terminate
- Ways in which the right to terminate can be lost
- Effect of termination
- Restrictions on termination rights
- Tips and pitfalls – termination decision mind map

Termination at common law

- A common law right to terminate a contract will arise upon:
 - breach of an essential term;
 - sufficiently serious breach of an intermediate term; or
 - repudiation of the contract.
- These grounds are not mutually exclusive
- Termination does not occur automatically

Termination at common law

Classification of contractual terms

- Categories of contractual terms:
 - **essential term** (condition) – breach gives rise to a right to terminate;
 - **intermediate term** – breach might give rise to a right to terminate; and
 - **non-essential term** – breach does not give rise to a right to terminate.
- A question of construction of the contract

Termination at common law

Essential terms

- *Tramways Advertising v Luna Park*:
 - “The test of essentiality is whether ... the promise is of such importance to the promisee that he would not have entered into the contract unless he had been assured of a **strict or a substantial performance** of the promise ... and that this ought to have been apparent to the promisor”
- Determine the parties’ intention based on the contract as a whole

Termination at common law

Essential terms

- Contract may expressly stipulate essential terms
 - Contract terminology is persuasive but not decisive
 - Implied terms can also be essential terms
- *Luna Park (NSW) Ltd v Tramways Advertising Pty Ltd* (1938) 61CLR286

Termination at common law

Intermediate terms

- An intermediate term is one that cannot be categorised as either an essential term or a non-essential term
- Right to terminate arises from serious breach of an intermediate term
 - A serious breach will go to the **root of the contract** and deprive the innocent party of the **substantial benefit** of the contract
- Assess gravity of breach and its consequences

Termination at common law

Intermediate terms

- *Koompahtoo Local Aboriginal Land Council v Sanpine*:
 - Joint venture agreement to develop land
 - Sanpine breached obligation to engage accounting services and to maintain all records and documents
 - This breach prevented Koompahtoo from assessing the financial position and making informed decisions
 - Breach sufficiently serious to justify termination

Termination at common law

Repudiation

- Repudiation is conduct which evinces an **unwillingness or inability** to render substantial performance of the contract
- Objective test
- A party should be ready and willing to perform their obligations at the time performance is due
- Repudiation can be express or implied

Termination at common law Repudiation

- Repudiation can be an existing breach or an “anticipatory breach” as to future performance
- Breach may amount to repudiation even if it is not breach of an essential term or a serious breach of an intermediate term
- Example: *Associated Newspapers v Bancks*

Termination at common law Repudiation

- Examples of repudiation:
 - Purported (invalid) termination of contract
 - Unwillingness to perform obligations
 - Inability to perform obligations
 - Fundamental breach of contract
- Conduct that may or may not amount to repudiation:
 - Asserting an incorrect understanding of the contract
 - Late performance or delay

Termination at common law Election to terminate or affirm contract

- Innocent party elects to affirm or terminate
- If contract affirmed, the right to terminate is lost
- Affirmation can be implied by:
 - continuing performance of contractual obligations; or
 - demanding performance from the other party.
- At common law, a party may only elect to terminate the whole contract

Termination at common law Effect of termination

- Both parties discharged from future performance
- Clauses intended to survive termination will remain binding
- Accrued rights are preserved, including damages for breach

Termination at common law Tips & pitfalls

- Wording not decisive to classify contract terms
- Time stipulations are not always essential
- Affirmation by conduct can arise from continuing performance of the contract
- Invalid termination can amount to repudiation (and give the other party a right to terminate)

Contractual rights to terminate

- Contractual rights to terminate are created by the contract. The wording of the contract (and construction of contractual terms) is key.
- A “default” (giving rise to a contractual right to terminate) might not involve a breach of contract
- If the innocent party does not follow the contractual mechanism for termination:
 - the right to terminate might not be validly exercised
 - the contract might not be terminated
 - the purported termination could itself amount to repudiation under common law
- Termination provisions in a contract may, or may not, reference common law rights

Contractual rights to terminate

Effect of termination

- Unless a contract says otherwise, upon a party validly exercising its contractual termination rights:
 - both parties are discharged from future performance
 - clauses intended to survive termination will remain binding
 - accrued rights are preserved
- However, a contract may stipulate other terms that apply upon termination, such as:
 - compensation payable for termination
 - transfer of assets eg. in a joint venture
- Unlike at common law, a contract can provide for termination of part of the contract eg. a particular service order

Contractual rights to terminate

Restrictions

- A party may lose its right to terminate by:
 - Affirmation of the contract
 - This requires conduct by the innocent party that is only consistent with continued existence of contract
 - Waiver
 - Waiver of contractual rights occurs when the innocent party (through words or conduct) unequivocally indicates abandonment of the right to terminate – but note “no waiver” clauses.
 - Estoppel
 - Conduct by the innocent party induces the other party to assume that the right to terminate will not be exercised
 - The other party relies upon the assumption to its detriment
- Obligation to act in good faith?
 - Will courts imply a contractual obligation on parties to exercise their rights in good faith?
 - No consensus within Australian courts but there is some guidance relevant to contractual termination rights

Contractual rights to terminate

Obligation to act in good faith

- An obligation to act in good faith includes (see NSW Court of Appeal in *Corden Investments Pty Ltd v Lesder Properties Pty Ltd*):
 - Cooperation to achieve contractual objectives
 - Compliance with honest standards of conduct
 - Compliance with standards of conduct that are reasonable
 - Note: does not require a party to act in the interests of the other party or to subordinate its own legitimate interests to those of the other party.
- *Trans Petroleum Australia Pty Ltd v White Gum Pty Ltd* (WA Court of Appeal):
 - Any obligation of good faith will not impose obligations inconsistent with the parties' bargain
 - Unlikely to apply to a party's exercise of express contractual rights to terminate (see later)

Contractual rights to terminate

Common examples

- Common contractual rights to terminate:
 - Termination for defined "default" event (often after a "remedy period")
 - Termination for convenience

Contractual rights to terminate

Termination for default

- Contracts often define the “default” event giving rise to a termination right
 - May or may not involve a breach of contract eg. insolvency event; change of control; extended force majeure
 - Contracts will often contain a “remedy period”
- Where a “default” is also a breach of contract, the innocent party may be able to choose to terminate:
 - under common law; or
 - pursuant to the contractual right.
- Different consequences arise from common law and contractual termination rights

Contractual rights to terminate

Termination for convenience

- Express right to terminate at any time and without a reason
 - Usually requires a period of notice
 - Does not require any breach of contract
- Example: (from *Trans Petroleum*)

“The Term.... of this Deed, shall continue from month to month with either party entitled to terminate this deed upon (2) months written notice to the other”

Contractual rights to terminate

Termination for convenience

- Termination for convenience is often challenged as breach of implied obligation of good faith
 - Any obligation of good faith unlikely to prevent a party from exercising its right to terminate for convenience
- *Trans Petroleum Pty Ltd v White Gum Petroleum Pty Ltd*
 - Court acknowledged unsettled law in Australia on implied duties of good faith
 - Held that:
 - The clause is an express and unequivocal right for either party to terminate without cause
 - No basis for concluding the clause was intended to permit termination only for a proper cause – it was a general and unfettered right of termination
 - To imply an obligation of good faith in the exercise of termination rights under the clause would be inconsistent with the bargain

Contractual rights to terminate

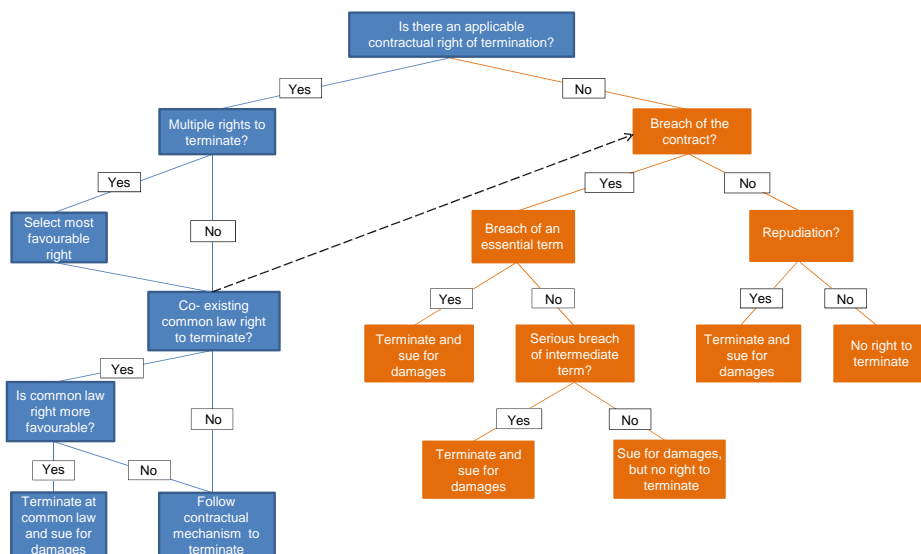
Contractual mechanisms for termination

- Critical that these are followed. Failure to properly terminate could result in invalid termination and repudiation of the contract.
- Traps
 - time periods – "Business Days"
 - remedy periods
 - method of delivery of notice
 - address for notice – section 109X of the Corporations Act (but see *Hill as Trustee for the Ashmore Superannuation Benefit Fund v Halo Architectural Design Services Pty Ltd*)

Contractual rights to terminate Tips & pitfalls

- Ensure strict compliance with contractual mechanisms for termination, including notice periods
- Ensure a right to terminate is not inadvertently lost
- Before terminating, consider effect of termination under the contract
- Draft practical termination clauses

Termination decision mind map



Conclusions

- Common law:
 - Breach of essential term, sufficiently serious breach of intermediate term or repudiation
 - Innocent party must elect to terminate or affirm
- Contractual rights:
 - Follow contractual mechanisms to terminate
 - Ensure right to terminate it not inadvertently lost
 - Consider effect of termination under the contract
 - Draft practical termination clauses
- Contractual rights do not necessarily displace common law
 - A terminating party may be able to decide which rights to exercise
 - When drafting contracts think about how termination rights will be exercised

Questions?

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