Contract Termination

This This publication is not intended to be a substitute for professional advice, and no liability is accepted.
The objective of this white paper is to suggest a general framework that may assist people seeking professional legal advice in their jurisdiction.

Overview

A contract is: ***A mutually binding agreement that obligates the seller to provide the specified products, services or results and obligates the buyer to provide monetary or other valuable consideration***.

The legally binding nature of a contract means that under normal circumstances, it cannot be terminated by one party without the agreement of the other party. There are some limited options for forced termination, both in law, and in the terms of many contracts, that may allow one party to enforce a termination over the objection of another, however, applying them is a high-risk option! If the enforced termination is subsequently found to be invalid, the action changes from 'termination' to 'repudiation' and potentially opens the party who took the action to terminate to significant claims damages and costs from the other party.

Basic Definitions

Contract Termination

To terminate a contract means to end the contract prior to it being fully performed by the parties, and therefore their duty to perform any incomplete obligations ceases to exist.

While the effect of the termination of a contract is generally to discharge the parties from their unperformed obligations, termination does not affect liabilities of the parties for breaches of the contract that occurred prior to the contract being terminated (including the act of termination). And where appropriate, the parties remain entitled to pursue claims for damages.

Contract Repudiation

Repudiation is the wrongful termination of the contract. Repudiation of the contract, is itself a material breach of the contract, and the disadvantaged party is entitled to pursue claims for damages. The key test of what is a repudiation, is whether the action or conduct amounts to "*evincing an intention to no longer be bound by the contract*". This may be evidenced by a wrongful termination, a *'material breach'* discussed below, or by a party repeatedly breaching non-essential terms of the contract, indicating that the breaching party had no intention of seriously making good its promises. These repeated small breaches can aggregate

This work is licensed under a Creative Commons Attribution 3.0 Unported License.
For more White Papers see: https://mosaicprojects.com.au/PMKI.php

into a repudiation allowing the aggrieved party to rescind the contract on the ground of repudiation but you won't know for sure until after a court makes its decision.

Termination Options

There are two basic types of termination:

1) Termination for cause, otherwise known as termination for default; and
2) Termination for convenience.

Termination for convenience can only occur if the terms of a contract provide for this type of termination, and even then, the termination has to strictly comply with the terms of the contract and not contradict the Law, contracts cannot override Law.

A termination for cause is only available in response to a **material breach** of the contract by the other party. A failure to perform any contract term is a breach of the contract but 99% of contract breaches are not ***material***. Normal breaches of contract are dealt with within the contract as disputes, most contracts have dispute clauses, and if a simple contract does not have appropriate clauses, there are legal rights to claim costs and damages for the breach. Material breaches of contract are in a whole different space.

A third option that may allow termination is if the contract becomes impossible to perform. If it is no longer possible to perform the contract considerations of '**force majeure**' and/or '**frustration**' may come into consideration. But be warned, impossible is a very high bar; it does not mean *more difficult* or *more expensive*!

Material Breach of Contract

A material breach entitles the non-breaching party to treat the material breach as a breach of the entire contract – therefore, the contract is terminated. What constitutes a material breach or default may be stated in the contract itself, for example, the contract may state if a party enters into bankruptcy the contract is terminated (but this condition may be overridden by legal constraints). In other circumstances, the materiality of the breach must be determined on a case-by-case basis and in light of the purposes for which the party entered the contract. The following facts are typically considered by courts in determining whether a breach was material:

- Was there a failure of an essential feature on the contract which had induced the non-breaching party to enter the contract?
- Did the breach go to the substance of the contract and defeat the non-breaching party's purpose for making it?
- Did the breach affect a matter of vital importance going to the essence of the contract?
- Did the non-breaching party receive substantially less or different from that which he had bargained to receive?

The overarching test is: *whether it appears from the general nature of the contract, or from some particular terms, that the promise is of such importance that the party would not have entered into the contract unless he had been assured of a strict or substantial performance of the promise*[1]. But, use with care! In the event a party seeks to terminate a contract without having justification under either the general principles of

[1] Jordan CJ referred to in *Tramways Advertising Pty Ltd v Luna Park* (1938) 61 CLR 286 at the lower New South Wales Court of Appeal (the case went to the High Court, where Jordan CJ's passage was approved).

This work is licensed under a Creative Commons Attribution 3.0 Unported License.
For more White Papers see: https://mosaicprojects.com.au/PMKI.php

contract law or under an explicit term of the contract, the action will backfire with the termination being defined as a wrongful termination, or repudiation (and that gets expensive).

Force Majeure & Frustration

Force Majeure is only available if there is a specific *Force Majeure* clause in the contract, it is not a common law right. Force Majeure clauses seek to deal with the impact on contracts of major events which are outside of the control of either contracting party, and govern the relief that is available both parties when it becomes impossible for one, or both parties to perform their obligations under the contract.

A force majeure clause will usually define the events that will trigger the clause such as: defined events specific to the contract, natural disasters, Government intervention, acts of war, etc. Generally, if there is a list of triggers, only the causes defined in the clause, trigger the clause (it does not have general application); a lot depends on the precise wording.

A current example of a potential force majeure is COVID-19, but unless your contract includes 'pandemic or epidemic' in the list of causes, the occurrence of COVID-19 is unlikely of itself to trigger the clause. But, most of the restrictions that actually affect the performance of contracts are imposed by Government regulation; if this is listed (and it commonly is), your trigger is the effect of regulations provided they make performance ***impossible***:

- If they do, you have a trigger,
- If they don't, you don't have a trigger, and
- If it is too soon to tell what the effect will be you still don't have the trigger.

As with termination, invoking a *Force Majeure* clause inappropriately can easily become a repudiation of the contract on your part (and that gets expensive).

If your contract does not contain a Force Majeure clause you may need to consider whether your contract has been *frustrated*. A contract can be frustrated where an event occurring after the contract was entered into, through no fault of the contracting parties makes performance impossible. In some jurisdictions there is specific legislation that deals with *frustration*, but in most locations, you need to negotiate or litigate a resolution to the contract and any adjustment between the parties for part performance.

The concept of '***impossible'*** (closely linked to *frustrated*), is hard to prove. Before seeking to trigger the clause, you should carefully consider all of the available options for the completion of the contract including any possible alternatives to mitigate the consequences of the occurrence. This may involve considering whether the entire contract is affected or whether there are parts of the contract that you can still complete. Consideration should also be given to whether there is only a temporary interruption to the performance of the contract or whether completion will in fact be impossible. Other clauses (for example 'extension of time' clauses) will be important considerations. Generally delayed completion and/or increased costs and/or increased difficulty rarely equate to impossibility.

Remedies for Repudiation

Damages available to the non-breaching party following its termination of the contract or in response to a wrongful termination by the other party include direct damages, consequential damages, and all other damages necessary to place the non-breaching party in the same position it would have been in should the contract have been completely performed by the parties.

This work is licensed under a Creative Commons Attribution 3.0 Unported License.
For more White Papers see: https://mosaicprojects.com.au/PMKI.php

In the context of a contractor wrongfully terminating its contract with an owner, the owner would be entitled to recover from the contractor the costs of hiring a replacement contractor to finish the Work, costs associated with delay of completion of the project including lost profits from use of the completed project, any additional costs for completion due to the termination, and any additional costs related to administration of the project, including additional costs for project management.

On the other side, in response to a client's wrongful termination, the contractor would be entitled to recover the cost of its work to the point of termination, plus all overheads incurred, plus lost profits and overheads on the rest of the work.

Recommended Option - Negotiate

In the event of a dispute, the difference between a lawful termination and a repudiation of the contract is likely to be decided by a Judge or Arbitrator after the event, with significant cost implications if somebody made a wring call – termination is a high-risk approach! The best way forward for both parties is to attempt to negotiate a mutually agreed termination if one party or the other is in difficulties, or as with COVID-19 the world has simply changed. There is very little gained by anyone if an unwilling or incapable party is forced by the other side to stay in a contract they cannot fulfil properly, or if the project itself no longer has any value.

A focus on outcomes rather than legal 'rights' will often help determine a solution that both parties can 'live with' and saves everyone a fortune in legal costs. You may still need a lawyer to draw up the termination agreement, but this is a lot cheaper than paying two sets of lawyers to fight a litigation. This type of negotiation is discussed in ***Negotiating in the midst of uncertainty*** [2].

Final Thoughts

While it is always better to negotiate then fight, obtaining a 'common sense outcome' is not always possible and there is a wrong way and a right way to end a contract. The correct method will be those situations where the other party is in substantial default under the contract in some way, and an initial notice of default (ideally, prepared by a lawyer) is served under the contract followed by a final notice.

That preliminary notice sets out the contract breach or breaches and requires the other party to rectify their default within the set time allowed by the contract (or a reasonable time if the contract is silent). It will also advise that if the default is not remedied within that time then the non-defaulting party reserves the right to serve a notice of termination. Only with delivery of the notice of termination is the contract regarded as being at an end.

Once the notice of termination is sent, more often than not the parties will end up in Court if significant monies are owed on either side. The sting is if the notices are subsequently found to be defective by the Court of Tribunal, it is quite likely the party issuing the termination will be found to have repudiated the contract…….

As suggested at the beginning of this White Paper, negotiation should be the first option. If that does not work and there is money at stake, refer to a lawyer. And unfortunately, once lawyers are involved, I cannot emphasise enough how important it is to have good paperwork and to ensure that all relevant documents, invoices and receipts are given to your legal representative; which means keeping your paperwork up to date throughout the project.

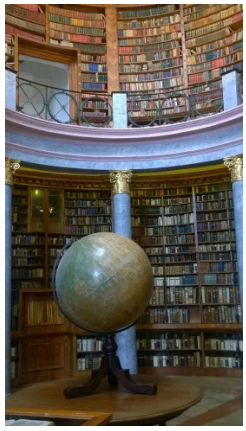
---

[2] ***Negotiating in the midst of uncertainty***, see: https://mosaicprojects.com.au/Mag_Articles/AA004_Negotiating_in_the_midst_of_uncertainty.pdf

This work is licensed under a Creative Commons Attribution 3.0 Unported License.
For more White Papers see: https://mosaicprojects.com.au/PMKI.php

An interesting up-side to good contemporaneous documentation is that by knowing what has occurred as a documented fact, you have the underpinning needed for effective negotiations and claims and as a consequence significantly reduce the instance of disputes. Conversely, the genesis of most disputes lays in a shared misunderstanding of what may have occurred (and both parties *know* their perceptions of the past are 100% accurate).

First published 20 May 2020.



Downloaded from Mosaic's PMKI Free Library.

For more papers focused on ***Contract Claims*** see:
https://mosaicprojects.com.au/PMKI-TPI-080.php

Or visit our PMKI home page at:
https://mosaicprojects.com.au/PMKI.php

Creative Commons Attribution 3.0 Unported License.

Attribution: Mosaic Project Services Pty Ltd, downloaded from
https://mosaicprojects.com.au/PMKI.php

This work is licensed under a Creative Commons Attribution 3.0 Unported License.
For more White Papers see: https://mosaicprojects.com.au/PMKI.php