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Risks in Terminating Contracts

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Introduction

Terminating a contract is rarely straightforward and can carry significant legal and financial risks if not handled correctly. Organisations must carefully assess their rights, obligations, and potential consequences before taking action, as wrongful termination can lead to significant financial claims.

This paper explores the key considerations, common pitfalls, and legal complexities involved in contract termination, providing guidance on how to navigate this challenging process.

Basis for termination must be clear

Before terminating a contract, organisations need to be confident of their rights. A purported termination of a contract by a party where a right does not exist might be taken as a repudiation of the contract enabling the other party to accept the repudiation and terminate the contract itself and claim damages.

Before terminating a contract, organisations need to carefully assess its position including:

- Assessing the termination rights under the contract and/or at common law.
- Assessing the basis and evidence for terminating the contract (ie for convenience or non-performance) and, if non-performance, whether the terms of the contract are sufficiently clear and proof of the failure to perform or meet a standard or level of care exists.
- Determining the process under the contract for terminating including the notices that need to be given and whether time to remedy is required (and whether a disputes process needs to be undertaken first).
- Determining the risks in terminating such as additional costs to the project due to the delay caused by the termination and appointment of a replacement contractor including delay costs payable to third parties and considering what, if anything, could be done to improve contractor performance.
- Weighing up the risks and costs in terminating against keeping the contract afoot.

Right to terminate

There are usually specific rights in a contract relating to termination. These might include:

- Termination for convenience.
- Termination for breach following a notice of breach and period of time to remedy.
- Immediate termination on the occurrence of certain events such as insolvency.

In addition to contractual rights (or if the contract is silent), there might be rights under the common law to terminate for breach of an essential term, sufficiently serious breach of an intermediate term, or repudiation (which is an unwillingness or inability to perform and could be an anticipatory breach). Noting that an express term in a contract might exclude common law rights and a breach of warranty may not create a common law right to terminate.

Risks with termination for convenience

It is often presumed that where there is a termination for convenience clause it is the 'safest' way to terminate a contract. This is not necessarily the case.

There is a risk that in exercising the right to terminate for convenience, a contractor might claim the organisation is not acting in good faith or that if contract is a standard form contract, the clause is in breach of the unfair contracts terms laws.

Good faith

Where a termination for convenience right is exercised, the terminated party could claim that the party exercising it is not acting in 'good faith'.

In a small number of contracts there is an express obligation for a party or a particular person (such as the superintendent in a construction contract) to act in good faith. But where there is no express obligation to act in good faith, a court would need to imply such an obligation as a term of the contract.

Whether there is an implied obligation to act in 'good faith' in contracting is not settled in Australia. The NSW courts have held that it is appropriate to imply a duty at act in good faith into *all* commercial contracts whereas the Victorian courts have held that there is no universal obligation but each arrangement should be assessed on the particular fact situation. In the Supreme Court of Victoria Court of Appeal in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum* [2005] VSCA 228, Justice Buchanan held that although there is not a general obligation to act in good faith it may be appropriate where a party was particularly vulnerable.

Even if it is found that there is a duty to act in good faith, it is not yet settled as to nature and content of the obligation. The Full Federal Court in *Virk Pty Ltd (in liq) v YUM! Restaurants Australia Pty Ltd* [2017] FCAFA focussed on the quality of the conduct to determine what is not acting in good faith – the acts needed to be capricious, dishonest, unconscionable, arbitrary or the product of a motive which was antithetical to the object of the contractual power.

In our view, where there is an unfettered right to terminate, it is going to be difficult for the terminated party to claim there is an implied duty to act in good faith as it will generally not be implied in contradiction to the terms expressly agreed by the parties. But this does not mean that they do not seek to make such a claim particular as the law is not settled in this area.

Unfair contracts

Where a termination for convenience right is exercised, the terminating party could claim that the termination for convenience clause is an unfair contract term in breach of Schedule 2 to the *Competition and Consumer Act* 2010 (Cth) which is known as the Australian Consumer Law (**ACL**) or *Australian Securities and Investments Commission Act* 2001 (Cth) (**ASIC Act**).

For a termination for convenience clause to be an unfair contract term in breach of the ACL the following needs to exist:

- The contract needs to be for the purchase of goods or services, financial products or a land transaction (including land sale, lease, residency agreement) with individuals for their personal, domestic or household use or with small businesses with 100 or fewer employees or who make less than $10 million in annual turnover if the contract us under $5m.

- There needs to be a 'standard form contract' – this requires an assessment of whether one party has all the bargaining power, if the contract is prepared without or before discussion with the parties, if the other party could only either accept or reject the terms as presented or was not given any real opportunity to negotiate the contract (including if the opportunity to negotiate related to terms that were minor or insubstantial in effect) and whether the contract takes into account any specific features of the other party or transaction. Interestingly, the contract is presumed to be a standard form contract unless a party proves it is not.
- The contract term needs to be 'unfair' which is where the term/s cause a significant imbalance in the rights and obligations of the parties under the contract, are not reasonably necessary to protect the legitimate interests of the party who gets an advantage from the term, and would cause financial or other harm to the other party if enforced.

The ACL and ASIC Act set out terms that may be unfair and this includes where the terms allow one party to terminate but not the other. A court would examine the entire contract to see if there are other terms that counterbalance this power, such as a right for the other party to terminate without penalty if they do not agree to a price increase.

The effect of the termination for convenience clause being an unfair term is that the term will be void. Accordingly, any termination made pursuant to that clause will be unlawful and penalties could be imposed.

Risks with construction contracts – show cause notices

In construction contracts, there is often a process whereby the principal issues a 'show cause' notice requesting the contractor show cause for an alleged breach before a notice of termination can be given. In the recent NSW case *Bundanoon Sandstone Pty Ltd v Cenric Group Pty Ltd; TWT Property Group Pty Limited v Cenric Group Pty Ltd* [2019] NSWCA 87 the principal issued a show cause notice and subsequently terminated the contract. The court found that the principal had a 'closed mind' and had already decided to terminate the contract regardless of the contractor's response (i.e. it was issued for an ulterior purpose). In this case, the court determined that the exercise of a power to terminate under a show cause regime is subject to an obligation of good faith and reasonableness.

The key message from this case is that care needs to be taken when terminating a construction contract after issuing a show cause notice. At least in NSW, where there is an exercise of a termination right after issuing of a show cause notice which wider than necessary to protect a party's legitimate interests, it might be subject to an implied obligation of reasonableness and good faith.

Risks with Termination for Anticipatory Breach

Anticipatory breach is where a party indicates they are not going to comply with the contract or that they will comply but in a manner which is inconsistent with its obligations. This differs fundamentally from an actual breach, which happens after the fact, when a deadline has passed or performance has failed.

There are greater risks in terminating for anticipatory breach especially if there is some uncertainty around a party's obligations under the contract. For example, it might be difficult to determine if a different method of delivery is substantially inconsistent with the party's obligations.

Examples of anticipatory breach include:

- Clear communication by an express statement that a party refuses to meet their contractual obligations;

- Actions indicate the party does not intend to meet its contractual obligations such as failing to prepare for performance, or a party sells assets needed for performance, or a party is close to insolvency creating uncertainty around performance.

For anticipatory breach, the courts have found that whether a party has an intention no longer to be bound by the contract, or only to fulfil it in a manner substantially inconsistent with its obligations, that intention is determined *objectively*, rather than by reference to the actual, subjective intention of the party.

Accordingly, due to the inherent nature of anticipatory breach, there are real risks associated with termination for anticipatory breach.

Dispute resolution

Prior to exercising a termination right, organisations need to consider if there are any dispute resolution provisions and whether the dispute resolution process needs to be undertaken prior to exercising any termination right. Failure to comply with the dispute resolution provisions might result in an unlawful or ineffective termination.

Delay risks affirming conduct

It is reasonable for a party to take some time to assess its options with respect to a breach by the other party to a contract. But care needs to be taken with respect to delays in acting on a breach. If a party acts in a manner that is consistent with the contract continuing, then in some circumstances it might result in the loss of the right to terminate.

Costs of terminating

Terminating the contract might seem the most straightforward way of dealing with a poorly performing contractor. However, invariably there will be costs associated with termination of a contract, especially where the contractor needs to be replaced. In addition to the costs of tendering and appointment of the replacement, delays might lead to delay costs being payable to other contractors engaged on the same project. In addition, market conditions might have changed so alternative suppliers might not be available or supply costs might have increased significantly over the intervening period. Further, there might be logistical challenges especially if the termination relates to construction or IT projects.

Consequences for getting it wrong

Where an organisation purports to terminate a contract without a right to do so, the termination will not be effective and might amount to breach by the organisation or, alternatively, repudiation of the contract allowing the other party to terminate and/or claim for damages. Further, wrongful termination would cause reputational damage to the organisation.

Conclusion

Organisations need to tread carefully when terminating a contract. Termination may initially seem like the most straight forward solution but, from experience, terminating a contract is never straight forward. Termination can be a complex process, weighing up the rights and benefits against all the risks and costs.

Seeking timely legal advice and following a structured process is essential to mitigate risks and protect organisational interests.

If you have any questions arising out of this paper, or would like further information, please do not hesitate to contact:

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