Terminating contracts

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Abstract

This paper carries out an examination of the current law relating to termination of contract. It provides an overview of the current law in general terms, examining recent cases and principals. It also looks at termination in relation to contracts more commonly seen in the building industry, providing specific clauses and a discussion of their effects. The paper then moves on to examine the consequences of termination of a contract and briefly examines the doctrine of frustration.

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INTRODUCTION

The current economic climate means that the termination of contracts is becoming more and more prevalent. 'Employers' are currently investigating their rights and ability to terminate contracts with much greater frequency than over the past 10 years or so, and all parties to a contract should be aware of their own rights and the rights of the other contracting party to terminate.

The crucial factor to consider when termination becomes an issue is what the contract actually says in relation to termination. This paper looks at the situation where:

1. there is either no written contract or there is a written contract but it does not expressly deal with termination; and
2. where there is a written contract containing a termination Clause and the types of clauses you can expect to see, particularly in construction contracts, facilities and maintenance contracts and tenancy agreements.

CONTRACT DOES NOT EXPRESSLY DEAL WITH TERMINATION

Where there is a written contract in place, you will usually find that it includes express provisions for the termination of the contract.

Irrespective of such provisions, or if no such provisions exists or there is no written contract, a party *may*, however, be entitled to terminate the contract where the other party to the contract is in breach of one or more terms in that contract. The implications of such are as follows:

1. breach of contract by one party;
2. the second (or innocent) party must 'accept' the breach in order to discharge (or end) the contract;

3. the result then is that the contract comes to an end and
4. the party in breach must still pay damages to the innocent party in respect of the breach.

The alternative scenario is:

1. breach of contract by one party;
2. the other (or innocent) party does *not* treat the contract as discharged or waives the breach and
3. as a result the contract does not come to an end.
4. The party in breach is still liable for damages, however.

Therefore, the two crucial issues that need to be investigated are:

- what kind of breach will allow the innocent party to terminate and
- how does the innocent party accept the breach in order to discharge (or bring to an end) the contract?

Innocent party accepts the breach

Dealing with the second issue first, the innocent party to the contract can accept the repudiatory breach and, upon acceptance, the contract comes to an end.

The alternative is for the innocent party to ‘affirm’ the contract so that the contract continues in force as before. It should be noted that once the contract has been affirmed, the innocent party cannot subsequently change his mind.

It is a fairly momentous decision to decide to bring a contract to an end. To do so, positive action is required from the innocent party to accept the repudiation. The contract will not come to an end automatically — action is required, and it must also be communicated by the innocent party to the party in breach.

In addition, if the innocent party does wish to accept the repudiation, it must not delay, or it may find that it has inadvertently affirmed the contract. It is very much a matter of degree as to what amounts to delay resulting in affirmation, and depends upon the duration of the contract and the facts of the case. If the party in breach resumes performance of the contract before the innocent party has accepted the repudiation, however, this may mean that the innocent party has lost the opportunity to repudiate. This is one area that often causes huge difficulties in determining whether a repudiatory breach has been accepted by the innocent party.

Circumstances justifying the termination of a contract

As has already been stated, terminating a contract is a fairly draconian step to take. The law therefore regulates this, and will not allow termination for minor indiscretions.

In order to terminate a contract, you must be able to show that the other party has behaved in such a way that justifies termination. This can be categorised in several different ways, as follows:

- (a) Refusal to perform the contract (or renunciation). This applies to a refusal to perform a contract generally, or to perform crucial terms of the contract. To succeed, it must be shown that the other party is in breach of a *condition of the contract* or has deprived the innocent party of the vast majority of the benefit of the contract.
- (b) An anticipatory breach where the innocent party is informed by the other party to the contract that it will not perform the contract at some point in the future. Again, the

innocent party would need to show that this was a breach of a condition of the contract or that it was deprived of the vast majority of the benefit of the contract.

- (c) Where performance is impossible because of the act or inaction by the other party.
- (d) Failure to perform the contract. Again it should be noted that this does not apply to all clauses in the contract. Essentially, it applies to clauses that can properly be categorised as 'conditions', and to breaches that go to what is known as 'the root of the contract', namely the basis and purpose of the contract.
- (e) Breach of a condition of the contract. A condition is a term that goes to the heart of the contract. Classification of a term as a condition can come through statute, previous judicial decisions or classification by the parties themselves. Classification by the parties themselves proves to be the most problematic part of a condition. There is nothing stopping the parties from classifying any term they wish as a condition. For example, in *Lombard North Central plc –v- Butterworth*, the parties stated that prompt payment of each instalment was a condition, and that failure to pay an instalment on time would mean that the contract was repudiated. The Court of Appeal allowed the Clause to stand. It must be shown, however, that the parties meant the term 'condition' in its technical sense.

To make matters even more confusing, a term can still be a condition even where it is not specifically designated as such. To be held to be a condition, breach of that term must have the consequence that the only proper interpretation is that the parties intended that the innocent party could treat himself as discharged, if the obligation was not fully and completely adhered to (*Hong Kong Fir Shipping Co Ltd –v- Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 260).

The most commonly used reason for termination in commercial contracts (in the absence of an express right to terminate the contract) is that of one party's refusal to perform their obligations under the contract. A recent case demonstrating this in practice is *Alan Auld Associates Ltd –v- Rick Pollard Associates and another* [2008] EWCA Civ 655.

In this case, the claimant was invited by the United Kingdom Atomic Energy Authority to tender for a consultancy to advise on a project to remove radioactive waste from a shaft at the Dounreay Power Station. The Claimant engaged the defendant to assist them, as his expertise lay in a specific area of the project.

The dispute related to the claimant's continued failure to make payments to the defendant on time. Nearly 2 years after the contract had been entered into, the defendant was owed over £21,000.00 by the claimant. In a telephone conversation, the defendant purported to end the contract and proceeded to work for another consultant who was also engaged in the same project. The claimant commenced proceedings.

The Court of Appeal was of the opinion that the claimant's conduct amounted to a repudiatory breach of contract. Although failure to make payment on time will not always amount to a repudiatory breach, the effect of the claimant's action was one in which the cumulative effect of the breaches was sufficiently serious to justify the innocent party bringing the contract to an end.

In this instance, the fact that the contract with the claimant was the defendant's only source of earned income, that the contract was analogous to a contract of employment, that the claimant had persistently and cynically failed to pay the defendant and the fact that the breach occurred against the background of repeated complaints by the defendant and broken promises by the claimant rendered the claimant's action sufficiently serious to be a repudiatory breach.

Consequences

Where the contract terminates, the obligations on both parties come to an end; however, the clauses for administering the termination and also the dispute resolution clauses are still enforceable. Similarly, the parties' liability for performance up to the date of termination still prevails.

Position of the 'innocent party'

The innocent party is released from his obligations under the contract. He is not bound to accept or pay for any performance by the other party, from which he has not derived any benefit. If the innocent party has derived benefit from the defaulting party, it is dependent upon whether that part performance can be separated from the performance as a whole. Any deposit paid is recoverable, as is any payment made in respect of goods or services that have not been issued or performed. He is also entitled to sue for damages for breach of contract.

Position of the 'defaulting party'

The defaulting party's obligations under the contract also come to an end. He is not entitled to recover any deposit or any damages for any resulting losses, however. It may be that the defaulting party can recover monies for part performance of the contract, but this is dependent upon whether that part performance is divisible from the contract as a whole. If it is, it may be possible to recover payment; if it is not, then the defaulting party must accept the loss.

WHERE THERE IS A WRITTEN CONTRACT CONTAINING THE TERMINATION CLAUSES, AND THE TYPES OF CLAUSES YOU CAN EXPECT TO SEE

Care must be taken even when the contract purports to confer an express right to terminate the contract on one or either of the parties, especially when the contract is intended to run for a long period of time.

In *Rice v Great Yarmouth Borough Council*, The Times, 26th July, 2000, the contract contained a term that allowed the Council to terminate 'if the Contractor commits a breach of any of its obligations ...'. The Court of Appeal held that the parties could not possibly have intended that the Council should be able to terminate for *any* breach, as to do so would 'fly in the face of commercial common sense' given that the contract was intended to last for 4 years. The Court were therefore of the opinion that the Council's right to terminate was only exercisable in the event of a repudiatory breach.

Some have argued that the insertion of the words 'substantial breach' or 'material breach' would mean that the courts would be more likely to give the Clause a favourable interpretation. Others contend that the insertion of such words only serves to open a debate as to what constitutes 'material' or 'substantial' breach. Further, it has been commented that this is an unusual decision and it may be that it is specific to its own facts.

That said, it is common to see express termination rights in contracts. The most common examples are forfeiture Clauses and Break Clauses in leases (both residential and commercial).

The British Property Federation has been attempting to promote fairness in commercial contracts, and its standard precedent (obtainable on their website) contains both a forfeiture Clause and a Break Clause:

'Forfeiture

18 The Landlord may forfeit this Lease by re-entering the Premises (or part of them as if entering the whole) if:

- (1) any Rent or other sums are overdue for 14 days or more (whether demanded), or
- (2) if any of the Tenant's Obligations under this Lease are not performed or observed, or

- (3) if the Tenant (being an individual) becomes bankrupt, or
 - (4) if the Tenant (being a company) enters into liquidation whether voluntary or compulsory (unless for the purpose of reconstruction or amalgamation) or has a receiver or administrative receiver appointed over any of its assets or is the subject of a petition for the appointment of an administrator, or
 - (5) if the Tenant enters into an arrangement or composition with creditors,
- and on re-entry the Term will end but the Landlord will retain any accrued rights in respect of breaches of the Tenant's Obligations'.

The above is essentially a right bestowed upon the Landlord to terminate the contract should the Tenant default on any of their obligations. In addition to the right to terminate, this Clause gives the Landlord the right to retake possession of the property.

In addition to the Landlord's right to terminate, the Break Clause (as drafted) gives both the Landlord and the Tenant the right to terminate on one months' notice:

'BREAK CLAUSE

24 Either the Landlord or the Tenant may give to the other not less than 1 months' written notice to end the Term on the [Finish Date of the Notice] or on any later date. Ending the Term will not release the parties from their accrued liabilities down to that date'.

Leases are not the only clauses that usually contain a termination provision. For example, the Joint Contracts Tribunal Minor Works Contract contains similar provisions allowing both the Employer and Contractor to terminate in specified circumstances:

'Default by the Contractor

6.4 .1 If before practical completion of the Works, the Contractor:

- .1 without reasonable cause wholly or substantially suspends the carrying out of the Works; or
- .2 fails to proceed regularly and diligently with the Works; or
- .3 fails to comply with clause 3.9,

the Architect/Contract Administrator may give to the Contractor a notice specifying the default or defaults (the "specified default or defaults").

.2 If the Contractor continues a specified default for 7 days from receipt of the notice under [the above clause], the Employer may on, or within 10 days from, the expiry of that 7 day period by a further notice to the Contractor terminate the Contractor's employment under this Contract'.

'Default by the Employer

6.8 .1 If the Employer:

- .1 does not pay by the final date for payment the amount properly due to the Contractor in respect of any certificate and/or any VAT properly chargeable on that amount; or
- .2 interferes with or obstructs the issue of any certificate due under this Contract; or
- .3 fails to comply with clause 3.9,

the Contractor may give to the Employer a notice specifying the default or defaults (the "specified default or defaults").

.2 If the specified default continues for 7 days from receipt of the notice under [the above clause], the Contractor may on, or within 10 days from, the expiry of that 7 day period by a further notice to the Employer terminate the Contractor's employment under this Contract'.

In addition, the GC/Works/10 Facilities Management General Conditions of Contract (2000) contains provisions for the termination of the contract by either party. In common with most commercial contracts, the Facilities Management Contract also contains a provision enabling the Employer to terminate the contract should there be a change in control of the Contractor. Although this does not appear to be common in construction contracts, it is unlikely to be controversial, as many commercial contracts incorporate such a Clause. The Clause is there to enable the Employer to terminate the contract should a competitor take over the Contractor company.

This is not the only termination provision in the Facilities Management Contract. The termination provisions in this contract are similar to those contained in a lease, in that

they allow either party to terminate for substantial default, and contain a 'Break Clause' exercisable by the Employer.

43 Determination on Default

Either party may determine the employment of the Contractor under the Contract, or determine the provision of any part of the Services, by written notice to the other Party with immediate effect if the other Party is in default of any obligation under the Contract and:

- (a) the other Party has not remedied the default to the satisfaction of the Party seeking to determine within 90 Days, or such other period as may be specified by the Party seeking to determine, after service of written notice specifying the default and requiring it to be remedied; or
- (b) the default is not capable of remedy; or
- (c) the default is a fundamental breach of the Contract.

44 Break

The Employer shall have the right to determine the employment of the Contractor under the Contract, or to determine the provision of any part of the Services (including without limitation, any Services being performed at any particular Site or at any building forming part of the Employer's Premises), at any time by giving 3 months' written notice to the Contractor. The Employer may extend the period of notice at any time before it expires, subject to agreement on the extent of the Services to be provided by the Contractor during the period of extension'.

It can be seen from the above clauses that they are very specific, in that they detail the exact circumstances that trigger the termination event. It is possible to include a more general termination option, but care must be taken, as it would appear that the courts are becoming more and more restrictive in their interpretation of these clauses. This restrictive interpretation by the Courts is reflective of the fact that they appear to be more willing to allow termination of leases as opposed to Construction contracts.

Frustration

A contract will effectively come to an end if it is frustrated. It is worthwhile noting when a contract will be frustrated, as this will essentially bring the contract to an end. It will be frustrated if performance is rendered impossible by an external change in circumstances where such situation has not been caused or created by the fault of the party relying on it. This is a very rare situation. Examples would include a change in law post-contract that prevents the performance of the contract or cancellation of an event upon which the contract is based. It should be noted that leases are very rarely frustrated. One possible example would be where the land that is the subject of the lease erodes into the sea.

CONCLUSION

Care must be taken in relation to termination of a contract, whether the right to terminate is expressly included or not. Before deciding whether to terminate a contract, the party must carefully examine its duties and the ambit of any termination Clause, especially if that Clause is expressed in general terms.

Where termination is not expressly provided for, the party wishing to terminate must fully examine whether the consequences of the breach are sufficiently serious to enable them to terminate. As termination of a contract is such a draconian measure, the consequences of incorrectly terminating a contract are equally severe.

Disclaimer: This paper is designed to alert professionals. It cannot replace nor is it designed to replace the need for advice on specific issues or circumstances.