



Termination of Commonwealth contracts

The premature end of a contract can have significant implications for both parties. In addition to the practical and commercial considerations, there are legal issues that will need to be taken into account to ensure that the best outcome is achieved.



John Scala
Chief Counsel Commercial
T 03 9242 1321 M 0418 679 003
john.scala@ags.gov.au



Paul Lang
Deputy General Counsel Commercial
T 03 9242 1322 M 0418 558 061
paul.lang@ags.gov.au



Kate Cabot
Lawyer
T 02 9581 7313
kate.cabot@ags.gov.au

There can be a range of different reasons why the parties to a contract want to end it prematurely – whether it is because of poor service delivery by the contractor or a failure by a grant recipient to comply with the requirements of a grant or a change in policy resulting in the cancellation of a program. In addition, sometimes external factors can result in a contract coming to an end. The way in which a party approaches ending a contractual relationship can have a significant impact on their legal position. A party needs to consider what outcome it wishes to achieve – to be put in the position it would have been in had the contract been performed or to be returned to the position it was in before the contract commenced.

The law in this area can be complex. A range of different legal principles are involved and potentially each has its own legal jargon. This note looks at some of the more common mechanisms for termination of a contract¹ and some of the practical considerations when preparing and terminating a contract.

¹ The word 'termination' is used throughout this note to refer to the ending of a contractual relationship. As noted above, in this area a range of legal jargon applies and the law is complex. This note does not seek to provide a comprehensive analysis of all the relevant legal concepts. Agencies should ensure that they obtain appropriate legal advice before taking action to end a contractual relationship.

In this issue

| | |
|---|----|
| How can a contract be terminated? | 2 |
| Termination for convenience: practical issues to consider | 4 |
| Considerations when preparing a contract | 9 |
| Considerations when terminating a contract | 10 |

How can a contract be terminated?

Most contracts include specific provisions that deal with termination. In addition, the general law (at common law and in equity) provides rights of termination that exist concurrently with any termination rights that are set out in the contract. Contracts can also be terminated by mutual agreement between the parties or set aside under the provisions of a statute.

Termination provided for in the contract

It is common for a contract to include provisions that deal expressly with the termination of the contract. In some cases, these provisions are largely restatements of termination rights that may otherwise be available under general law. In other cases, the provisions include additional or expanded termination rights. Set out below is a brief discussion of some of the more common termination clauses included in contracts.

Termination for default

A termination for default clause usually gives a party the right to terminate the contract if the other party fails to perform the contract in accordance with the requirements of the contract (often referred to as a 'default'). The right to terminate is usually in addition to any other rights that may arise as a result of the default, such as the right to seek damages for any loss suffered as a result of the default.

The scope of a party's rights will depend on the drafting of the clause. In addition to a failure to perform the contract in accordance with its terms, it is common for these clauses to specifically identify other events that will be deemed a default and trigger the right to terminate. Examples of default events that are often contained in contracts include:

- a failure to perform the contract as required, sometimes by reference to specific provisions such as meeting the timetable or achieving milestones, service delivery, management of grant moneys etc
- failing to remedy or address a breach in accordance with the contract's requirements
- a change in control or the ownership of the contractor
- a failure to satisfactorily resolve a conflict of interest affecting the contractor
- a failure to comply with the security, confidentiality or privacy requirements
- a failure to comply with any express contractual representations/warranties that have been provided by the contractor.

'In drafting a "termination for default" clause, you should carefully consider when the clause should be triggered...'

Where a party is a corporation, the contract will often include express provision for termination in the event the corporation comes under some form of external administration. This clause will cover situations where the corporation voluntarily goes into administration or has an order made against it to place it under administration. A contract may also provide for termination to cover cases where the contractor becomes insolvent or if a corporation becomes bankrupt or enters into a scheme of arrangement with creditors or defaults under other material contracts.

In drafting a 'termination for default' clause, you should carefully consider when the clause should be triggered, taking into account the subject matter of the contract and the objectives that a party is trying to achieve.

Termination for convenience

Many Commonwealth contracts contain a 'termination for convenience' or 'termination without default' clause. Most termination for convenience clauses in Commonwealth contracts are 'one-way' – that is, they are only for the benefit of and only exercised by the Commonwealth.

In addition to providing for the termination of the contract, it is common for these clauses to give the Commonwealth the option to 'reduce the scope' of the contract. Where the clause provides this option, it is important that the clause clearly sets out the process that is to be followed and the obligations on the parties associated with the reduction in scope. In addition to reviewing the services or activity under the contract, this will often involve a renegotiation of price, as well as reconsideration of timeframes and personnel. A termination for convenience clause will often provide for compensation to be paid to the contractor by the Commonwealth. This will cover work completed or costs reasonably incurred by the contractor before the termination date and any additional expenses or costs that are necessarily going to be incurred by the contractor as a direct result of the early termination.

The decision to include a termination for convenience clause is a matter for individual agencies (in the case of FMA agencies, acting in accordance with their chief executive instructions and having regard to the requirements of the financial management framework). Without a termination for convenience clause, agencies may not be able to unilaterally terminate contracts in the event of a change of government policy or other government exigencies² (see the section on doctrine of executive necessity on page 7).

'...it is advisable to seek legal advice before relying on a termination for convenience clause.'

Good faith

The courts have considered the question of whether a government party has a duty to act honestly and in good faith when relying upon a termination for convenience clause. There is recent case law supporting an obligation by Governments to only use the clause in good faith.³ However, other cases suggest that an implied term of good faith when exercising a contractual right, where the right to terminate is provided in clear and express terms, does not necessarily apply in the private sector.⁴ As the law on this does not appear settled, it is advisable to seek legal advice before relying on a termination for convenience clause.

² *NSW Rifle Association Inc v The Commonwealth of Australia* [2012] NSWSC 818.

³ *Kellogg, Brown & Root Pty Ltd v Australian Aerospace Ltd* [2007] VSC 200.

⁴ *Sundarajah v Teachers Federation Health Ltd* [2011] FCA 1031; *Trans Petroleum (Australia) Pty Ltd v White Gum Petroleum Pty Ltd* [2012] WASCA 165; *Starlink International Group Pty Ltd v Coles Supermarkets Australia Pty Ltd* [2011] NSWSC 1154; *NSW Rifle Association Inc v Commonwealth* [2012] 266 FLR 13 (although note that there was no termination for convenience clause in the contract in question); *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15.

TERMINATION FOR CONVENIENCE PRACTICAL ISSUES TO CONSIDER

Is a termination for convenience clause required?

Check your agency's chief executive instructions or other internal procedures to find out. Consider whether to obtain legal advice.

Should the clause be 'one-way' for the benefit of the Commonwealth or provide each party with the right to terminate?

Some contractors will seek to amend these clauses to allow both parties to terminate for convenience, often raising it as an issue of fairness. You should carefully consider the practical implications of the contractor being able to unilaterally terminate the contract at any time having regard to the specific reasons put forward by the contractor as to the circumstances in which they might wish to exercise such a right.

What notice period should apply?

This will vary depending on the subject matter of the contract and should take into account both practical considerations (that is, how long it will take to wind-up activity under the contract) and policy considerations (that is, how quickly you will want to be able to implement the termination). If termination is as a result of a change in Government policy, you may wish to be able to act very quickly.

Does the clause also need to allow for a reduction in scope?

Determine whether the clause will operate to terminate the entire agreement, allow for a reduction in the scope of the contract or provide for both outcomes. An issue to consider here is whether the contract covers a 'single matter' – such that reduction in scope may not be practical – or a range of more discrete tasks or activities.

Has liability for termination been limited?

Consider what kinds of costs or compensation should be paid to the contractor and whether an overall cap should be placed on the amount that can be claimed by the contractor – for example, by limiting any compensation to an amount equivalent to the unpaid balance of the contract price as at the date of termination.

If the other party claims compensation, can the compensation be justified and is it carefully described?

You should always require the contractor to verify any claims (independently where possible) for compensation. Ensure that the contract contains a clause that obliges the contractor to verify any claims for compensation and to provide you and your advisers with access to their records for this and audit purposes.

Have transitional issues been considered?

Issues such as the treatment of records, finalisation of accounts or reports, transfer of any assets or transition to any new service delivery arrangements should be addressed. Consider whether the payment of any compensation should be made conditional on the contractor satisfactorily completing any transitional steps.

Force majeure and termination

A *force majeure* event is an event beyond the control of the parties to the contract – for example, a natural disaster – that causes one or more parties to be physically or legally unable to perform their contractual obligations.

Force majeure clauses usually allow:

- the affected party to avoid liability for non-performance if the circumstances fall within the ambit of the clause
- the parties to terminate or adapt their contract if a *force majeure* event occurs and continues for a period of time.

Usually the clause first deals with ‘freezing’ the contract for a period of time until the *force majeure* event ceases. This generally only applies to those contractual obligations which are affected by the *force majeure* event. Once the event ceases, the obligations recommence and the contract continues. The clauses usually provide for a right to terminate the contract if the *force majeure* event remains in force for a long period. This right to terminate reflects the fact that where a contract remains ‘frozen’ for an extended period of time, the benefit of keeping the contract ongoing is likely to be significantly reduced (for both parties). See also the discussion of ‘frustration’ below.

Conditions precedent and conditions subsequent

A ‘condition precedent’ is a condition or requirement contained in the contract that must occur or be met for the contract to come into effect. If the event does not occur or the requirement is not met, the contract does not commence. Parties may also include a ‘condition subsequent’ in the contract – the difference here is that the contract has commenced, but it will be terminated automatically if a particular event occurs.

Examples of common conditions precedent include a requirement for a contractor to obtain a necessary licence or regulatory approval before commencing work under the contract, obtaining insurances, providing a parent company guarantee or bank guarantee or finalising subcontracting arrangements with a major subcontractor.

Examples of common conditions subsequent include having a required regulatory approval revoked or the loss of an accreditation necessary to perform the contract.

Termination under the general law

In general terms, the law provides rights of termination that exist concurrently with any termination rights that are set out in the contract.

A right to terminate may arise under the general law in a number of different circumstances, including where there is:

- breach of an essential term
- repudiation
- a frustrating event
- fraud/misrepresentation.

It may also arise under the doctrine of executive necessity.

Breach of an essential term

If a term is considered an essential term of the contract (sometimes referred to as a 'condition'), non-performance of this term may be considered by the other party as a failure to perform the contract as a whole. A term can be considered an essential term if:

- a breach of that term is likely to cause serious loss or detriment⁵
- the parties indicate that they consider the breach a serious matter by an implied agreement between the parties that the term is to be treated that way.⁶

If a party breaches an essential term of a contract, the other party can usually terminate the contract and claim damages. A serious breach of a non-essential term can also give rise to a right to terminate the contract. The distinction between an 'essential' and a 'non-essential' term and what constitutes a sufficiently serious breach that brings about a right to terminate may not always be clear. It is advisable to seek legal advice before attempting to terminate on these grounds.

'If a party breaches an essential term of a contract, the other party can usually terminate the contract and claim damages.'

Repudiation

Repudiation occurs where one party renounces their liability under a contract or shows through their actions an intention to no longer be bound by the contract.⁷ A party usually has a right to terminate if the other party repudiates the contract. Repudiation does not automatically bring a contract to an end. If a party seeks to terminate on the basis of repudiation, they must 'elect' to terminate the contract (usually by notifying the other party of this intention), otherwise the contract will remain on foot. It is not necessary for a party to be in breach of its obligations under the contract for it to have repudiated the contract – for example, a repudiation may occur where a party expresses a clear intention not to perform its obligations, even if the time for performance has not occurred.

Frustration

A contract can be frustrated where an event occurs or a situation arises without fault by either party that undermines the contractual relationship between the parties. It is the effect of the supervening, or 'frustrating', event that gives rise to a right of termination. Events that create different circumstances to those that were agreed under the contract events that deprive the party of substantially the whole benefit that was the intention of the parties as expressed in the contract⁸ have been held to constitute frustration. At common law, frustration automatically discharges the contract. Both parties are relieved from further performance of their obligations under the contract from the time of the event. Unconditional rights and liabilities accrued before the frustrating event occurred remain unaffected by the termination of the contract. Examples of events that could lead to frustration of a contract include the outbreak of war and the compulsory resumption of property by a government.

'Examples of events that could lead to frustration of a contract include the outbreak of war and the compulsory resumption of property by a government.'

⁵ *Wallis v Pratt* [1910] 2 KB 1003, 1012.

⁶ *Luna Park (NSW) Ltd v Tramways Advertising Pty Ltd* (1938) 61 CLR 286.

⁷ *Shevill v Builders Licensing Board* (1982) 149 CLR 620, 625–626

⁸ *Hongkong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26 at 66; [1962] 1 All ER 474; [1962] 2 WLR 474 per Diplock LJ, CA.

The common law does not recognise any doctrine of *force majeure* (see above). Therefore, without a *force majeure* clause (which, as noted above, usually provides for a contract to be ‘frozen’ rather than terminated – at least initially), the doctrine of frustration could result in a contract being terminated.

Fraud/misrepresentation

A contract can be ended where the contract is induced by fraud. Fraud or a fraudulent misrepresentation takes place where a fraudulent or false statement is made by the representor with the knowledge that it is untrue. The test of fraud is subjective and the relevant question is whether the representor believed that the representation was true.⁹ In some circumstances a contract can also be ended for innocent or negligent misrepresentation. The usual remedy sought here is for the parties to be returned to their ‘pre-contractual’ position – as though the contract never happened. The availability of this remedy depends in part on whether it is in fact possible to do this.

Doctrine of executive necessity

A contract may be terminated at common law under the doctrine of executive necessity. This doctrine gives a government an option to terminate a contract where the contract fetters or purports to fetter statutory executive discretions and powers. This doctrine is based on the rationale that it would be in the public interest to terminate the contract in such circumstances.

‘A contract may be terminated at common law under the doctrine of executive necessity.’

Courts have defined the doctrine’s scope by reference to:

- ‘overriding public interest, such as the exigencies of war’¹⁰
- ‘performing a statutory duty or exercising a discretionary power conferred by or under a statute’¹¹
- ‘common law powers and functions of the Crown or the Executive when they involve making decisions in the public interest’.¹²

In the recent case of *NSW Rifle Association Inc v The Commonwealth of Australia* [2012] NSWSC 818, the Court found that the doctrine of executive necessity could not be relied upon to terminate a licence for use of land where the Commonwealth had changed its position on the future use of the land. In general terms, a consideration here was a finding that the entry into the licence was not an exercise of a statutory power or a Commonwealth prerogative but rather an exercise of the Commonwealth’s power as owner of the land.

Other circumstances in which a contract can be set aside

A contract can also be set aside where a party was induced to enter the contract by a ‘wrongdoing’ recognised in equity. Circumstances where a contract may be set aside include where a party has entered into the contract as a result of undue influence exercised over that person by another party or where one or both parties have entered into the contract under a mistake of fact.

9 *John McGrath Motors (Canberra) Pty Ltd v Applebee* (1964) 110 CLR 656; *Akerhielm v De Mare* [1959] AC 789; *Seymour v Australian Broadcasting Commission* (1977) 19 NSWLR 219.

10 *Northern Territory of Australia v Skywest Airlines Pty Ltd* (1987) 48 NTR 20, 46.

11 *Ansett Transport Industries (Operations) Pty Ltd v Commonwealth* (1977) 139 CLR 54 at 74–75.

12 *Attorney-General (NSW) v Quin* (1990) 170 CLR 1 at 18.

Termination by mutual agreement

Any contract can be terminated where both parties agree to terminate. This can be done either by an express clause in the contract or because both parties agree that they would like to end the contract. The usual rules of contract formation (offer, acceptance, consideration and intention) will apply to establish whether the parties have agreed to terminate the contract.¹³

Termination or unenforceability under legislation

The *Corporations Act 2001* (Cth) and the *Competition and Consumer Act 2010* (Cth) are just 2 examples of legislation containing provisions to set aside a contract because of a breach. For example, under the Competition and Consumer Act, a contract can be set aside because of misleading and deceptive conduct or because of a major failure in the supply of works.

Chapter 5 of the Corporations Act makes provision for external administration, which may be relevant to parties that contract with corporations. In general terms, if a company is being wound-up, this chapter makes provision for the transactions of that company to be voidable at the option of the liquidator in certain circumstances.¹⁴

¹³ *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 52 ALJR 20; *Fitzgerald v Masters* (1956) 95 CLR 420; *Tekmat Pty Ltd v Dosto Pty Ltd* (1990) 102 FLR 240.

¹⁴ *Corporations Act 2001* (Cth), s 588FE.

CONSIDERATIONS WHEN PREPARING A CONTRACT

When drafting a contract, it is important to consider the appropriate termination mechanisms for the contract. As discussed above, even without specific provisions in the contract, the right to terminate can still arise at general law. However, it is usually better to specify the termination rights as far as possible in the contract. The contract can also be used to set out the process to be followed to terminate the contract.

Things to consider when drafting a contract include the following:

- In what circumstances will you want to terminate the contract?
- What actions or breaches of which provisions in the contract should be specified as acts of default that could trigger termination?
- Is termination for convenience appropriate? Should it be a one-sided or a mutual right? Should it include a right to reduce the scope of the contract? Are notice periods appropriate? What level of compensation should be paid?
- Should either party have the option to terminate at particular milestones?
- What is the process for termination? Can the parties terminate immediately for breach or should the contract provide for alternative dispute resolution mechanisms to operate before a party can terminate? Are there any exceptions?
- What happens after termination?
 - Who will provide the services or complete the works? Is continuity of services important?
 - What is required for successful transition to a new contractor? Provide for the transition in the contract.
 - What equipment, materials and intellectual property are needed? Who will have ownership or control of these under the contract?

CONSIDERATIONS WHEN TERMINATING A CONTRACT

Terminating a contract can be a difficult exercise and getting it wrong can lead to significant drain on resources and involve significant time and costs, and lead to litigation. Taking steps to terminate a contract without justification is often itself a repudiation of the contract that may allow the other party to exercise a right to terminate the contract and sue for damages. Therefore, it is usually appropriate to seek legal advice before taking any steps to terminate a contract.

Things to consider when terminating a contract include the following:

- What termination rights are provided for in the contract? Are any of the general law termination rights applicable?
- Are there any express or implied limitations on the right to terminate? Consider whether an obligation to act in good faith may apply or whether the right to terminate may have been waived by the actions of the parties.
- Pay careful attention to preservation of rights clauses under the contract (that is, clauses that survive the termination of the contract. These often include indemnities, rights of access, obligations on parties to keep information confidential and so on).
- Be clear on what basis you are proposing to terminate. Is it for default or convenience? Act consistently and be able to justify your actions.
- Be careful, by your acts or omissions, not to waive any right to terminate.
- Consider the costs of termination and the impact on any underlying program.
- Can a mutually agreeable outcome be reached?
- Manage the relationship appropriately.
- Follow the process set out in the contract (for example, those for notice, cure periods and so on).
- Seek legal advice on the legal effect of the mode of termination. Consider if any property will need to be restored to its pre-contract owner.
- What happens after termination?
 - What is your 'plan B' to complete the services/works?
 - In the case of a grant, do you have an interest in the ongoing delivery of the services that are supported by the contract? If so, how will this be arranged?
 - In the case of a procurement, how quickly can another contractor be engaged? Consider the Commonwealth Procurement Rules and whether an approach to market is required.
 - What equipment, materials or intellectual property are required? Who owns or controls these? Will these need to be transferred to a third party?
 - Have a transition plan.
 - What level of cooperation is required from the contractor? Are they likely to provide this?

Other issues

There are a number of other issues that impact on termination of contracts.

See also the following AGS publications:

- Commercial note 33: *Securities: Ensuring payment of debts to the Commonwealth*
- Commercial note 35: *Managing government contracts through financial distress*
- Legal briefing 96: *Personal Properties Securities Act*
- Legal briefing 97: *Commonwealth grants: An overview of legal issues.*

This publication was prepared by John Scala, Paul Lang and Kate Cabot.

John Scala is AGS's Chief Counsel Commercial. His specialist expertise in corporate and commercial law includes tendering and contracting, procurement, corporate governance, privatisation, probity and process advice and auditing, banking and finance, property and leasing, and outsourcing projects. Over his 33 years in commercial law, John has worked for a wide range of Commonwealth departments and agencies.

Paul Lang is Deputy General Counsel in AGS Commercial. Paul has advised the Australian Government on many significant and complex projects. He has over 22 years' experience in public sector procurement, tendering and contracting, probity and process advice, privatisation, corporatisation, outsourcing, and grants and funding agreements.

Kate Cabot is a lawyer in AGS Commercial. Kate has experience in advising on a range of commercial issues including procurement, tendering and contracting, property, grants, probity and intellectual property. She advises a wide range of Commonwealth agencies on contracting issues and has completed secondments with a number of agencies.

AGS contacts

AGS has a national team of lawyers specialising in termination of Commonwealth contracts. For further information on this issue, or on other matters, please contact the authors or any of the lawyers listed below.

Canberra

| | |
|------------------|--------------|
| Chris Behrens | 02 6253 7543 |
| Rachel Chua | 02 6253 7086 |
| Kathryn Grimes | 02 6253 7513 |
| Helen Curtis | 02 6253 7036 |
| Terry De Martin | 02 6253 7093 |
| Andrew Miles | 02 6253 7100 |
| Linda Richardson | 02 6253 7207 |
| Adrian Snooks | 02 6253 7192 |
| Jim Sullivan | 02 6253 7578 |
| Zita Rowling | 02 6253 7426 |
| Tony Beal | 02 6253 7231 |

Sydney

| | |
|---------------|--------------|
| Simon Konecny | 02 9581 7585 |
| Jane Supit | 02 9581 7408 |
| Kate Brophy | 02 9581 7678 |

*The material in this briefing is provided to AGS clients for general information only and should not be relied upon for the purpose of a particular matter. Please contact AGS before any action or decision is taken on the basis of any of the material in this briefing.
© AGS All rights reserved*

Offices

| | |
|------------------|--|
| Canberra | 4 National Circuit, Barton ACT 2600 |
| Sydney | Level 42, 19 Martin Place, Sydney NSW 2000 |
| Melbourne | Level 21, 200 Queen Street, Melbourne VIC 3000 |
| Brisbane | Level 12, 340 Adelaide Street, Brisbane QLD 4000 |
| Perth | Level 19, 2 The Esplanade, Perth WA 6000 |
| Adelaide | Level 18, 25 Grenfell Street, Adelaide SA 5000 |
| Hobart | Level 8, 188 Collins Street, Hobart TAS 7000 |
| Darwin | Level 3, 9–11 Cavenagh Street, Darwin NT 0800 |

www.ags.gov.au

Electronic versions of AGS newsletters are available for clients who prefer to receive issues in this form.

For enquiries regarding supply of issues, change of address details email ags@ags.gov.au

ISSN 1448-4803
Approved Postage PP 233744/00042