

# Commercial notes

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## TERMINATION FOR CONVENIENCE

When entering into agreements, Commonwealth agencies often need to consider the possibility that a change in government requirements may require an agreement to be terminated or the scope of the agreement to be reduced. This note discusses some of the issues that agencies need to consider in relation to this type of non-fault-based termination or reduction, which is often referred to as 'termination or reduction for convenience'.

Many Commonwealth procurement or funding agreements contain a termination for convenience clause. These clauses operate to allow the Commonwealth to terminate the agreement where there is no fault by the other party. Typically, these clauses provide that the Commonwealth may, at any time, by providing notice to the contractor or funding recipient, terminate the agreement in whole or in part. If the Commonwealth exercises its rights under such a clause, the clause will typically state that the Commonwealth will be liable only for direct costs (excluding any loss of prospective profits) incurred by the contractor or funding recipient which are directly attributable to the termination or partial termination.

The principal reason for the inclusion of termination for convenience clauses is to enable the Commonwealth to terminate its commitment in the event of a change of government policy or other related government exigencies. The decision to include these clauses in agreements 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). If an agency purports to terminate an agreement where the agency does not actually have a right to terminate, the other party may be able to successfully challenge the termination with a resultant claim for damages or other relief. For this reason it is important to understand the circumstances in which an agreement may be terminated for convenience.

### Doctrine of executive necessity

A termination for convenience clause is usually justified in Commonwealth agreements as reflecting the doctrine of executive necessity. Broadly stated, the doctrine is simply that the law permits the government to fulfil the fundamental purposes for which it was created, even though this may interfere with contractual rights. This doctrine reflects public policy considerations in that a government (or perhaps more particularly a future government) should not be prevented from making future changes to government policy.

Even where a termination for convenience clause is not included in the procurement or funding agreement, the Commonwealth may still be able to terminate by relying on the doctrine of executive necessity. It is prudent to seek legal advice before relying on the doctrine of executive necessity as a basis for terminating an agreement.



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## Drafting and negotiating the agreement

Obviously, it is important to consider what termination rights the agency requires at the time the agreement is being drafted.

### *Illusory consideration?*

It has been argued that a strict interpretation of a termination for convenience clause would render an entire agreement void and therefore unenforceable. This argument is based on the premise that, as the clause would permit the government to terminate the agreement at any time at its convenience, the government's performance of its obligations is arguably 'optional': the government promises nothing and thus provides no consideration for the agreement; hence, there is no agreement.

The inclusion of the requirement for the Commonwealth to pay compensation to the contractor or funding recipient upon termination mitigates against this risk. Rather than rendering performance optional, the clause permits the Commonwealth to decide how it will perform the agreement (either by seeing the agreement through to the end or by paying the contractor compensation). Consequently, it is unlikely that a court would find a procurement or funding agreement void and unenforceable by virtue of the inclusion of a termination for convenience clause.

### *Developing termination provisions*

There are many factors that need to be considered in developing the termination provisions to be included in an agreement. For simpler agreements, more standard provisions may be adequate, but for more complex agreements it may be necessary to tailor the termination provisions to the transaction. Examples of some of the issues that may need to be considered are as follows.

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## Some issues to consider in developing the agreement

- Ascertain whether your agency's Chief Executive Instructions or other internal procedures require the inclusion of a termination for convenience clause in the relevant agreement. It can be helpful to refer to this requirement if a potential contractor queries the inclusion of the clause.
- Whether the agency presses for a termination for convenience clause in a particular agreement should be informed by the overall requirements of the financial framework and, in the case of FMA agencies undertaking procurements, against value for money criteria. For example, if the inclusion of a termination for convenience clause will significantly increase the price at which the contractor is prepared to enter into the agreement, this would need to be weighed up against the benefit derived from the termination right.
- Determine whether the agency requires a right to terminate for convenience in whole or part. Consider the appropriateness of the provisions in the event of a termination which results in a reduction of the scope of the agreement. Ascertain what contractor actions and obligations should continue in the event of a reduction of the scope of the agreement.
- One of the key reasons for including a termination for convenience clause is to limit the compensation that is payable to a contractor in the event that the termination proceeds; in particular, to focus the compensation on the payment of reasonable costs following from the termination and avoid the need to pay compensation for loss of future profits or other benefits. Accordingly, it is important to carefully consider how the compensation is described in the agreement. For example:
  - Is compensation for future profits excluded?

- **Is there a limit on the maximum liability of the agency in relation to direct costs** (for example, to the unpaid balance of the agreement price or, under a funding agreement, to the unpaid balance of the funds at the time of termination)? If there is no limit, a claim might exceed the cost of leaving the agreement afoot.
  - **In the case of agreements which enable the contractor or funding recipient to acquire assets from the procurement or funding payments, how are those assets to be dealt with at the time of termination and is this relevant to determining what compensation is payable?**
  - **Consider the impact of payments to subcontractors in the event of termination.** To limit the direct costs unavoidably incurred by a contractor in the event of termination for convenience, will the contractor's agreements with subcontractors be required to contain provisions that the subcontract is terminated if the head contract is terminated for convenience (with restrictions on any compensation payable to the subcontractor)?
  - **What mechanism will be needed to verify any claim for compensation in the event of termination for convenience?** Access to contractor records and the ability to audit a compensation claim may be necessary to determine the reasonableness of the contractor's claim.
- Consider the duration of the agreement: termination for convenience is often a more significant consideration for longer-term agreements.

### *Negotiating termination provisions*

In negotiating the inclusion of a termination for convenience clause, it can be useful to point out that the Commonwealth may still be able to terminate by relying on the doctrine of executive necessity and that the payment of compensation in such circumstances is not certain. In contrast, termination for convenience clauses typically provide for the payment of compensation for loss incurred as a result of the termination. However, in doing so, agencies should take care not to represent that the right to terminate for convenience provided in the agreement can or will be exercised only in limited circumstances (such as where the doctrine of executive necessity would otherwise have been applicable or where there is a major change in government policy), as, by making these representations, agencies may inadvertently restrict the scope of the contractual clause.

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### **Must termination for convenience rights only be exercised in good faith?**

One of the issues that needs to be considered when determining whether to terminate an agreement on the basis of a termination for convenience clause is whether the clause can be taken at face value or whether there are limitations on the agency's right to terminate such that the exercise of the right to terminate is not free from risk. In particular, is the agency required to act in good faith in exercising a right to terminate? If so, what does that mean?

#### *Is there an implied term requiring the parties to act in good faith?*

There are no clear answers to this question under Australian case law. The High Court has yet to endorse the implication of a term of good faith into a commercial agreement.<sup>2</sup>

However, lower courts have endorsed the implication of a term of good faith, but such a term has been implied in some cases as a matter of fact and in others as a matter of law. Implication of the term in law has been on the basis that such a term will ordinarily be implied in some, or perhaps all, commercial agreements

as a 'legal incident of the relationship'.<sup>3</sup> The result of implying the term in law is that the term is implied into all contracts belonging to that class, although the express terms of a particular contract can exclude it.

In contrast, the Victorian Court of Appeal seems to hold a preference for such a term to be implied, if at all, in fact rather than in law, meaning that the implied term of good faith is implied on an ad-hoc basis to give effect to the presumed intention of the parties. Those who argue for a duty of good faith to be implied as a matter of fact (i.e. on a case-by-case basis) argue that to imply a duty of good faith as a matter of law (i.e. to all contracts in a particular class) would undermine certainty in commercial contracting and ignore the traditional test for an implied term, including that it be capable of clear expression and be so obvious that it goes without saying.<sup>4</sup>

In the recent Victorian Supreme Court case of *Kellogg Brown & Root Pty Ltd v Australian Aerospace Ltd* [2007] VSC 200 (*Kellogg*), Hansen J commented that:

... perusal of the authorities reveals a deal of obiter on the issue. Further, the High Court is yet to consider the issue. The question, of course, is whether in the particular case in question the terms of the subject contract permit the implication of the suggested term.

In this case, Australian Aerospace (AA) mirrored in its subcontract with Kellogg Brown the termination for convenience clause which was in its own contract with the Commonwealth. When AA exercised that right of termination for convenience by giving Kellogg Brown a notice of termination, Kellogg Brown contested the matter, arguing that the notice constituted a breach of an implied term in that it was not given in good faith and reasonably, for just cause, or upon proper and reasonable grounds. Judgment has not been given in this case. Once it has, the issues of termination for convenience and the existence of a duty of good faith implied in such clauses will hopefully be clearer.

Aside from the comments of Hansen J in *Kellogg*, recent cases in various Australian jurisdictions have tended to proceed on the basis that there may be implied, as a legal incident of a commercial contract, a term of good faith. However, given that the position in Australian law (and particularly in Victoria) is not clear, it may be that a duty to act in good faith is not to be implied generally into all commercial agreements. Such a term would be implied only if the particular facts and circumstances of the commercial arrangement required or supported this.

Regardless of the uncertainty about whether such a term is to be implied and if so how, agencies need to be aware of the risk that the exercise of the right to terminate for convenience may be limited by a duty to act in good faith.

#### ***If there is a duty of good faith, what does it encompass?***

If there is a duty to act in good faith in relation to a particular agreement, whether expressly provided for or implied as discussed above, the scope of that duty is also not entirely clear.

It would appear from authorities that reasonableness now seems to be regarded as a significant ingredient of good faith and, in many cases, there is little distinction made between the two concepts.<sup>5</sup> Beyond the reasonableness requirement, cases on the topic have not clarified the meaning of 'good faith' or its practical requirements but have suggested that good faith could perhaps mean:

- (a) acting honestly<sup>6</sup>
- (b) not acting capriciously<sup>7</sup> and
- (c) doing what is necessary to enable the party to have the benefit of the agreement.<sup>8</sup>

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It is equally unclear what circumstances would be found to constitute bad faith or an abuse of discretion. Some have argued that using the power for an exterior or ulterior purpose such as seeking a better commercial deal elsewhere, or to avoid potential liability for default under the agreement or preventing other parties from exercising their rights, would not comply with a duty of good faith and fair dealing. If these arguments were upheld, it would mean that a termination for convenience clause could not simply be used according to its literal terms; that is, for the 'convenience' of the government.

Even if a good faith duty is expressly included in the agreement, the rights under a termination for convenience clause will not necessarily be restricted. Authorities have suggested that the duty of good faith is not a fiduciary duty and will not prevent a contracting party from taking actions which promote its legitimate interests and accord with express contractual terms.<sup>9</sup> In particular, such authorities have expressed the view that:

- an express term in an agreement that the parties would act in good faith did not limit the operation of the termination for convenience clause
- a clear and unambiguous power of termination, expressed as an absolute and uncontrolled discretion, is not required to be exercised reasonably merely by virtue of the existence of a requirement to act in good faith
- a contractual obligation of good faith does not prevent either party pursuing legitimate commercial interests, even though the pursuit of those interests may result in the renegotiation or termination of the agreement
- a term could not be implied that the termination power was limited to situations where the principal had a reasonable reason for terminating, because such an implied term would be contrary to the express termination provision
- the implication of any terms (such as the term of good faith) which inhibited the operation of the express words of the agreement would be contrary to principle; it is clear that an implied term of good faith must be consistent with the express terms of an agreement
- the obligation of good faith cannot prevent the use of terms actually appearing in the agreement.

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#### **Termination for convenience in the government context**

Termination for convenience clauses in government agreements are not often exercised and there has been no consideration of this type of termination in the government context by Australian, United Kingdom or New Zealand courts. The United States has a long history of dealing with termination for convenience clauses in the government context. Therefore, if such a clause came before an Australian court, the court may look to United States case law for assistance.

In *Torncello v United States* 681 F 2d 756 (1982) (*Torncello*), the court held that the US Government could exercise a standard termination for convenience clause only in circumstances where 'the bargain of expectations of the parties have changed sufficiently that the clause serves only to allocate risk'. Subsequent US cases have interpreted the *Torncello* decision as broadly requiring a change in circumstances as a prerequisite to a valid termination for convenience. However, more recent cases have rejected or limited the *Torncello* decision.<sup>10</sup>

Following the decision in *Krygoski Construction Company v United States* 94 F 3d 1537 (1996), the position in the US appears to be that use of a termination for convenience clause will be improper only where the government has acted in bad faith or there has been an abuse of discretion. Examples of bad faith include where the clause is used to acquire a better bargain from another source, or where the government enters into an agreement with no intention of fulfilling its promises.<sup>11</sup>

If a court followed the trend in the United States, it might find that the Commonwealth may only exercise the right to terminate for convenience in 'good faith'. As noted above, under Australian law, it is unclear whether a duty to act in good faith exists generally in contractual dealings as a matter of law. However, even if there is no general duty of good faith and fair dealing, it is possible that a court would consider that such an obligation should be implied as a matter of fact into a particular Commonwealth agreement; for example, on the basis of the particular circumstances that apply to the agreement.

In *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1, Finn J found that, in a pre-award or tender process agreement, the then Civil Aviation Authority (CAA) owed an implied contractual duty to tenderers to deal with them fairly. His Honour's principal finding was that there was a preliminary 'process' agreement governing the conduct of the tender before the award and that there had been breaches of that agreement, the primary breach being that the CAA had 'failed to evaluate tenders in accordance with the priorities and methodology prescribed in the RFT'.<sup>12</sup>

The case is quite fact specific and does not necessarily stand for the proposition that there is a general duty of good faith in government agreements.

### Conclusion on good faith

Given the uncertainty in the state of the law on good faith in contracting generally and the absence of specific authorities in Australia on termination for convenience clauses, it is important to take specific advice *before* any decision to terminate for convenience is taken. If a duty of good faith is applicable, the precise requirements of that duty might also vary depending on the nature of the agreement.

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### Practical considerations when terminating for convenience

Some of the issues that are required to be considered in the context of a termination for convenience are similar to those that may need to be considered on expiry of an agreement (for example, transitional type issues) or on a termination for default. Other issues are more specific to a termination for convenience.

The following are examples of some of the issues that may require consideration depending on the nature of the agreement.

#### Some issues when considering terminating for convenience

- Consider whether, in making the decision to terminate for convenience, the agency has acted in good faith.
- Ascertain whether the termination is for the entire agreement or is limited to a reduction of the scope of the agreement.
- Determine the extent of the agency's obligation to compensate the other party in the event of termination for convenience. Unless the agreement limits the agency's liability to compensation for costs unavoidably incurred, a compensation claim may exceed the total agreement price or the total amount of funds to be advanced.
- Ascertain the steps that may need to be taken to verify the claim for compensation and the resources required to undertake the verification.
- Consider the transitional issues that will need to be dealt with as a result of the termination and how these are provided for in the agreement (for example, in relation to the treatment of records, finalisation of accounts or reports, or treatment of assets).

- Consider the potential impact on any future relationship with the other party and other participants in the relevant market as well as any impact on the Commonwealth's broader policy or program goals.
- Consider whether any representations were made by either party during negotiation of the agreement in relation to the circumstances in which the right to terminate for convenience could be exercised.

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## Notes

- 1 There are a number of requirements and policies that make up the financial management framework; for example, the *Financial Management and Accountability Act 1997*, the *Financial Management and Accountability Regulations 1997* and the *Commonwealth Procurement Guidelines*.
- 2 As noted by Dodds-Streton J in *Meridian Retail v Australian Unity Retail Network* [2006] VSC 223, referring to *Royal Botanical Gardens and Domain Trust v South Sydney City Council* (2002) 186 ALR 289.
- 3 Finkelstein J in *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703 (*Garry Rogers*) and more recently in *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* [2005] FCA 288. Finn J of the Federal Court also supported this view in *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (2003) 128 FCR 1 (at 173-174).
- 4 For example, Buchanan JA (with whom Warren CJ and Osborn AJA agreed) in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228 (*Esso*) at para [25], Warren CJ in *Esso*, and Hansen J in *Playcorp Pty Ltd v Taiyo Kogyo Ltd* [2003] VSC 108 at [267]. The decision of Giles JA in *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15 (20 February 2004) (*Vodafone*) is cited in the judgment for an opposite approach.
- 5 *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234; *Burger King v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (*Burger King*).
- 6 Giles JA in *Vodafone* at para [192].
- 7 Finkelstein J in *Garry Rogers* at para [37].
- 8 Giles JA in *Vodafone* at para [192].
- 9 *Burger King*; *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* (2000) 16 BCL 255; Dodds-Streton J in *Meridian Retail v Australian Unity Retail Network* [2006] VSC 223, referring to *Central Exchange Ltd v Anaconda Nickel Ltd* (2002) 26 WAR 33; *Commonwealth Bank v Spira* [2002] NSWSC 905. See also relevant English authority *Hadley Design Associates Ltd v The Lord Mayor and Citizens of the City of Westminster* [2003] EWHC 1617 (TCC).
- 10 For example, *Krygoski Construction Company v United States* 94 F 3d 1537 (1996).
- 11 See *Northrop Grumman Corp v United States* Fed Cl, 7 April 2000; *T & M Distributors Inc v United States* 905 F2d 1518 1990; *Caldwell & Santymer Inc v Glickman* 55 F3d 1578 1995; *Travel Centre v General Services Administration* GSBICA 14057, 26 November 1997.
- 12 (1997) 146 ALR 118.

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