AUSTRALIAN GOVERNMENT SOLICITOR

Commercial Notes

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Standardised Funding Agreements

AGS has been working with a consortium of agencies since May 2001 to standardise funding agreements across the Commonwealth. The agencies involved fall under the *Financial Management and Accountability Act 1997* (Cth), and the standardised agreements are intended to be used for providing funding to communities, that is, when agencies make a general call for applications for funding. The agreements could be adapted for use in other circumstances, such as where funding is under a statutory program. This work has been done under the More Accessible Government Initiative administered by the Department of Transport and Regional Services.

Three standardised funding agreements have been developed: long form, short form and minimalist form. The titles reflect the complexity and length of the documents. Accompanying each of the three agreements are guidelines which provide explanation and assistance for program managers in constructing and administering the agreements. There are also general guidelines which provide assistance in determining which of the funding agreements to use in a particular situation. The determination is based essentially on risk, but not merely financial risk.

The standardised funding agreements reflect the decision which each of the regular consortium members (being the main funding agencies in dollar terms) had already reached independently as to the nature of such agreements; that is, that they should be contracts rather than gifts or grants (for a discussion of the difference see *Commercial Notes*, Number 4, 28 November 2001 'Nature of the Legal Relationship under a Grant'). This approach is accepted by the Australian National Audit Office:

> 4.9 Where a contract is chosen, it is important to avoid uncertainty regarding the legal relationship. The contract should not be called a 'grant contract' nor 'grant agreement', should not include any reference to a 'grant' or 'grantee' and should include all the normal provisions of a contract such as termination and applicable law provisions. [1]

Generally, agencies do not regard funding as being subject to the Commonwealth Procurement Guidelines (CPGs) made under Regulation 7 of the Financial Management and Accountability Regulations 1997 as funding is not used to procure goods or services for the Commonwealth.

It may be that agencies choose to use a procurement style process to select funding recipients, but this is for reasons of transparency and accountability in regard to expenditure of public money, rather than for reasons of application of the CPGs.

This issue

The form of the three standardised funding agreements is different, even though they are all contracts. The long form is in a traditional contract style and is executed in the normal way by the parties. The short form and the minimalist form contracts are entered into by exchange of letters. All three forms reflect policy positions agreed to by agencies as a common starting point on issues (for example, ownership of intellectual property created by the funding recipient).

The three standardised funding agreements and guidelines are available for use now by agencies. Though use of them is a matter for individual agencies because of a Chief Executive's individual responsibility under section 44 of the Financial Management and Accountability Act, their use is seen as consistent with efficient, effective and ethical use of Commonwealth resources by the agencies which contributed to their development.

Individual agencies may modify an agreement to suit particular circumstances but it is intended that agencies keep track of such changes and submit them to a review to be conducted in December 2003 by the More Accessible Government Working Group.

Notes

1 *Administration of Grants – Better Practice Guide*, Australian National Audit Office, May 2002 (available at www.anao.gov.au)

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Terminating Contracts for Non Performance

Sirway Asia Pacific Pty Ltd v Commonwealth

Federal Court of Australia
[2002] FCA 1152, 18 September 2002

This case serves as a reminder to parties engaged in contracts to be cautious when negotiating contract variations and considering termination for non performance.

Facts

In 1996, the Commonwealth (the Department of Defence) issued a Request for Tender for the supply of crockery for a period of three years under a standing offer agreement (the Standing Offer). The Standing Offer required that the crockery be supplied to meet the specifications set out in the Standing Offer. The specifications covered size, shape and colour, as well as levels of chip resistance and water absorption. The applicant submitted a tender and was the successful tenderer, with the Standing Offer being signed on 11 August 1997.

The first purchase order under the Standing Offer was raised in August 1997, with a further purchase order raised in October 1997. At the same time, there were discussions between Commonwealth personnel and the applicant concerning finalisation of the working samples. These discussions focused on the size, shape and badging of the crockery. In January 1998, the Commonwealth advised the applicant by letter that the working samples had been approved. This letter specifically noted that this approval did not relieve the applicant from the requirement to comply with the specifications.

The first delivery of crockery was made in May 1998. Random testing of the crockery showed that it did not meet the specifications, particularly in relation to water absorption. Meetings were held

with the applicant in June 1998. The applicant asked for assistance in finding an alternative method of disposing of the defective crockery, with the result being the purchase of the crockery at a discount.

In September 1998, the applicant advised the Commonwealth that it was unable to meet the specifications. Following further discussions between the parties, the Commonwealth terminated the Standing Offer in December 1998.

Allegations

The applicant commenced legal action in the Federal Court against the Commonwealth. The applicant's claims against the Commonwealth were based on a number of grounds, including:

- breach of the Standing Offer, on the basis that in meetings between Commonwealth personnel and the Contractor, the Commonwealth personnel agreed to the variation of the specification set out in the Standing Offer; and
- breach of an implied obligation to 'act in good faith, fairly and not capriciously in exercising a power conferred by the contract', relying on *Hughes Aircraft Systems v Air Services Australia* (1997) 76 FCR 151.

Findings

In relation to the first issue, Justice Sundberg found that no variation of the specification had been agreed between the parties and as such there had been no breach of the Standing Offer. In relation to the second issue, Justice Sundberg found that the Commonwealth had not acted unfairly or capriciously in exercising its right to terminate the Standing Offer.

Trade Practices Act

The applicant also made claims under the *Trade Practices Act 1974* (the TPA), on the basis that the Commonwealth had engaged in:

- misleading and deceptive conduct (s.52); and
- unconscionable conduct (Part IVA).

Justice Sundberg noted that section 52 and Part IVA will only apply to the Commonwealth if '*it was carrying on a business and in the course of carrying on that business engaged in the conduct that is the subject of the claim*'. He referred to *JS McMillan Pty Ltd v Commonwealth* (1997) 77 FCR 337 and the judgment of Justice Finkelstein in *Corrections Corporation of Australia Pty Ltd v Commonwealth* (2000) 104 FCR 448, in which Justice Finkelstein states that the expression *'carrying on a business'* is intended to refer to activities of the Commonwealth that are *'undertaken in a commercial enterprise or as a going concern'*.

The applicant's argument was that in calling for tenders and entering into a contract for the supply of crockery, Defence was carrying on the business of trading in chinaware. Justice Sundberg noted that this 'alleged' business is supportive of Defence's core function and that in determining whether the acquisition of chinaware amounted to the carrying on of a business, it was '*relevant to bear in mind that the Department's primary activity does not amount to the carrying on of a business'*. He concluded (at para 62):

> Because the Department's trade in or acquisition of chinaware so obviously relates to the execution of a government function which is in the interests of the community, it does not have the characteristic of carrying on a business. … Because I am considering an activity that is of a subsidiary priority when compared to the Department's main function, my conclusion regarding the true purpose for which the activity is performed is informed by the principal government duty that is discharged by the Department.

As such, the TPA did not apply. In any event, Justice Sundberg found that even if the TPA did apply, the claims would not have been successful.

The applicant was ordered to pay the Commonwealth's costs.

Summary

The case illustrates the importance of careful contract management particularly in dealing with a contractor who is unable to meet its obligations. Had Commonwealth personnel been less cautious in their discussions or in drafting correspondence, it is possible that Justice Sundberg may have found that the specifications had been varied. In this context, it is relevant to note that the Commonwealth first sought legal advice on its options and the appropriate steps to be taken relatively early in the process – after the initial meetings with the applicant following the delivery of the defective crockery. This ensured that subsequent action, including accepting some of the crockery at a discount, did not prejudice the Commonwealth's right to take action under the Standing Offer.

It also shows the importance of keeping accurate and contemporaneous records of any meetings and of confirming the outcome of meetings in writing. Many of the facts of this case, particularly in relation to the conduct of the parties and the outcome of discussions, were in dispute and, in most instances, the Court accepted the Commonwealth's submissions on these issues.

The case also provides a useful summary of the application of the TPA to the Commonwealth, particularly in relation to the tendering and contracting out of 'non core' functions.

Text of the decision is available at http://www.austlii.edu.au/au/cases/cth/federal_ct/2002/1152.html

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Termination for Convenience Clauses

Many Commonwealth contracts and funding agreements contain a termination for convenience clause which provides that the Commonwealth may, at any time, by providing notice to the contractor or funding recipient terminate the contract or agreement in whole or in part. If the Commonwealth exercises its rights under this clause it will only be liable 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 such clauses is to enable the Commonwealth to terminate its commitment in the event of a change of government policy or other related government exigencies. There is no general Commonwealth policy documentation which dictates or otherwise generally recommends the use of termination for convenience clauses.

The decision for inclusion of such clauses in contracts is a matter for individual departments and agencies (acting in accordance with their Chief Executive Instructions).

Possible Risks

The exercise of the right to terminate under a termination for convenience clause by the Commonwealth is not free from risk. It has been argued (eg, in *Torncello v United States*[1]) that a strict interpretation of a termination for convenience clause would render a contract void and therefore unenforceable. This is because the consideration provided by the Commonwealth would be illusory and would render performance by the Commonwealth effectively optional. This argument has been relied on in the United States. However, inclusion of the requirement for the Commonwealth to pay compensation to the contractor or funding recipient

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

Interestingly, *Torncello* appears to no longer reflect the United States position on termination for convenience – United States law now appears to be that the inclusion of such a clause does not invalidate the contract, and the exercising of rights under such a clause will be improper only where the government has acted in bad faith, or there has been an abuse of discretion: *Krygoski Construction Company v United States*. [2]

Noting this recent trend in the United States, it is possible that a court would find that the Commonwealth may only exercise a right to terminate for convenience in 'good faith'. It is likely that an Australian court would imply an obligation of good faith into a termination for convenience clause even if one was not explicitly included. Given this requirement of 'good faith', it would not be appropriate for the Commonwealth to seek to exercise its rights under a termination for convenience clause, for example, to acquire a better bargain from another entity, or to avoid potential liability for default under the contract or funding agreement or where the Commonwealth has from the outset no intention of fulfilling its promises.

Doctrine of Executive Necessity

If the termination for convenience clause is not included in the contract or funding agreement, the Commonwealth may still be in a position to terminate by virtue of the doctrine of executive necessity. Broadly stated, the doctrine operates to ensure that a government is able to fulfil the fundamental purposes for which it was created, even though this may interfere with contractual rights of others. As such, the absence of a termination for convenience clause will not necessarily prevent the Commonwealth from terminating the contract or funding agreement at some point in the future. However, the exact nature and scope of the doctrine of executive necessity at common law is unclear and has rarely been considered in detail by the courts. Relying on the doctrine of executive necessity alone may potentially limit the grounds upon which the Commonwealth could terminate a contract or funding agreement – for example, it may be limited by a court to a change in government policy.

Although not historically part of the doctrine, it is also now likely that a court would require the Commonwealth to pay compensation to a contractor or funding recipient in the absence of a specific termination for convenience clause. It is not clear how such compensation would be calculated or what it would cover. It is possible that it could extend beyond 'direct' costs and include consequential and indirect costs.

Conclusion

A termination for convenience clause requires that the Commonwealth act in good faith to avoid the need to terminate the contract or funding agreement. It does not expressly require the Commonwealth to only exercise the right where there has been a fundamental change in government policy. It may be that the requirement to terminate the funding agreement or contract arises not as a result of a change in government policy per se but a change in the method of achieving or delivering that particular government policy.

It is questionable whether the doctrine of executive necessity would allow the Commonwealth to terminate in these circumstances. The Commonwealth could argue that these circumstances come within the scope of the termination for convenience clause, and that the clause regulates the consequences for the Commonwealth exercising

such a right (the payment of compensation to the contractor or funding recipient).

One of the things agencies need to consider is to ensure that the contract includes provisions to limit as far as possible the direct costs incurred if there is a termination for convenience – for example by requiring similar termination for convenience clauses to be included in contracts with subcontractors.

Notes

1 See *Torncello v United States* 681 F 2d 756 1982

2 94 F3d 1537 (1996)

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