Termination for convenience


Kevin McGuinness


Stephen Bauld

BY DEFINITION, A CONTRACT is a legally enforceable agreement. It follows that contracts cannot ordinarily be terminated easily, except by mutual consent. Nevertheless, when elections loom in the near future, purchasing departments can expect to be hearing soon from newly elected councillors, members of legislatures or parliament and ministers or their staff. They will enquire whether it is possible to terminate one contract or another because the majority of the new government no longer agree with the "policy" that gave rise to the contract.

The general answer to this question is that a change of policy does not allow any level of government to terminate an existing contract. A fully executed contract (i.e., one in which, for instance, property has been bought or sold and all payments made) cannot be undone except in very unusual cases. For contracts that have not reached this stage of completion, the general answer remains the same – but there are certain qualifications that apply to it. Using a municipality as an example:

(a) Where a contract is of an indefinite duration, it is terminable on reasonable notice. Accordingly, a new council may direct municipal staff to give notice of termination, so as to bring the contract to an end.

(b) Where a contract is for a specified term, subject to possible renewal at the end of that term on mutual consent, the municipality is not obliged to renew, and may elect not to renew due to a change in policy, even though the other party has fully and well performed the contract during its previous term. However, such a right to walk away is not available where the other party has an "option" to renew at the end of the contract.

(c) Some municipal contracts reserve an express right in favour of council not to provide necessary funding after the end of the current year's budget. If no such funding is voted, then the contract will lapse by its express terms.

More rarely, contracts may include an express right in favour of the municipality to terminate them on notice. The following is an example of such a clause.

> "The City may terminate the contract, or any part thereof, by written notice to Seller, for any or no reason, as the City may determine to be most convenient to it. Upon notice of termination, Seller shall immediately stop all work and cause its suppliers or subcontractors to stop all work in connection with the Order. If the City terminates for convenience, the City shall pay Seller for goods and services accepted as of the date of termination, and, subject to Section 8, for Seller's actual, reasonable, out of pocket costs incurred directly as a result of such termination. The City shall have no responsibility for work performed after Seller's receipt of notice of termination."

It will be noted that the above provision does not allow the municipality to get out of the contract at no cost. It must still pay the "breakage" costs of the supplier, which can be substantial. Such breakage costs include re-shelving costs, relevant worker severance or other termination payments, in all probability the full cost of redundant equipment, and supplies, and any other loss, cost, charge or expense incurred by the supplier in connection with early termination of the agreement. Although breakage costs can be substantial, the municipality still saves in the area of variable cost, and also the supplier's anticipated profit margin.

Generally, it is unwise for a municipality to seek to include language in a contract providing it with a unilateral right to terminate the contract. Although in theory discretionary rights to terminate a contract for convenient can be drafted so as to permit escape free of any breakage cost responsibility, for the following reasons this is almost always an exceptionally unwise course:

(a) Such a policy will almost certainly reduce the number of potential bidders. Reduced competition usually leads to a higher price.

(b) Many suppliers will refuse to bid for a contract that is so uncertain in scope. Since good suppliers tend to attract good customers, a municipality that seeks broad unilateral rights of termination runs a serious risk of being serviced only by poor suppliers.

(c) Most importantly, such a policy introduces additional risk from the supplier's perspective. Prudent suppliers will price that risk into their bid price.

While it is possible to sweeten the pot by providing further protection to the supplier (e.g., guaranteeing that the expected profit will also be paid on termination), such an approach usually makes the termination of a contract prohibitively costly. To get out of the deal, the municipality will pay a very large portion of the total price, and have little to show for having done so.

The main reason for shying away from discretionary termination provisions is that they sour the supplier-customer relationship. Many municipalities include in their contracts a statement that they are to be accorded "most favoured customer" treatment. However, broad rights of termination undermine a healthy working relationship with a supplier. Most suppliers are loyal to the customers who are loyal to them. Unilateral rights of termination do not suggest loyalty.

Steve Bauld spent many years as purchasing manager at the City of Hamilton and is now vice president of the Ontario General Contractors Association. Kevin McGuinness is a lawyer with Ontario's Attorney General. Together they have collaborated on several books about procurement and leadership.