News

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# Uneconomic Contracts: Protecting your business in the downturn

In these unprecedented times, most organisations will be looking to protect their business interests. Contractual arrangements will come under closer scrutiny. Wholesale reviews of all leases, long-term supply agreements, contractor agreements, agency agreements and distribution agreements are recommended. Use this as an opportunity to insulate and protect contracts from challenge by another contracting party wishing to terminate what may have become for them an unprofitable contract. Conversely, you may be looking to terminate a contract that no longer fits into your business strategy or which, having been entered into at the peak of the market, now represents a bad deal. A comprehensive review of contracting arrangements can help to identify grounds for termination and the associated consequences and risks.

## WHAT IS MY CONTRACT?

The first step in this review exercise is to identify and locate the full contractual arrangement.

From our experience, many organisations will not have a complete set of their contracting arrangements. Where signed contracts cannot be located, it is important that a complete picture of the relationship is determined. This will include understanding the length of the relationship (which may be determinative on reasonable notice requirements) and what documentation may underpin the relationship through course of dealings (such as purchase order terms). Organisations should not assume the absence of a written contract means the absence of a contract. In terms of usefulness in understanding and protecting your rights under a contract, ideally an original signed contract should be located, failing that a copy of it, failing that an unsigned copy and failing that all documentation evidencing the terms of the contract.

## CAN I TERMINATE ON NOTICE?

Many organisations will have an extensive range of contractual agreements (especially those with heavy IT requirements). Generally, these will have express terms enabling them to be terminated on notice and a common tactic is to use these notice provisions to drive down reductions in rates. This is achieved by either threatening to or actually terminating on notice to achieve either a re-negotiation on cost or to walk away from the relationship altogether. While such a tactic is legitimate, it is important that you pre-determine, before adopting this approach, whether any contractors have unique skills that may need to be retained and who may be alienated by this approach.

Organisations also need to consider certain statutory provisions that are often over-looked in the context of terminations, for example the Commercial Agents (Council Directive) Regulations 1993, where the scope of who is considered a “commercial agent” has been enhanced through recent judicial decisions and may catch a wider type of person (eg “introducing agents”) than most organisations anticipate. This means that compensation may now be payable on termination to the “agent” even where this was never contemplated at the outset of the agreement.

## CAN I TERMINATE FOR BREACH OR FRUSTRATION?

Most commercial contracts will allow a party to terminate for cause, for example, for non-payment of invoices or late delivery. Where such a clause exists, you should check carefully to see if a breach or default by the other party entitles you to terminate the contract forthwith or on notice and whether you need to give the other party an opportunity to remedy the breach or default.

In certain circumstances, you may be entitled to treat the contract as having been terminated by reason of the other party’s breach. This is commonly known as “discharge by breach” or “repudiatory breach”. You should seek advice if you think a contract has been terminated by breach. Not every breach of contract is a repudiatory breach. Also, if you are the party

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faced with a possible repudiatory breach you must choose whether to treat the contract as continuing (affirmation) or to bring the contract to an end (acceptance of the repudiation). If you choose to affirm the contract (and this can be done by conduct as well as by express words) that choice becomes irrevocable and you may lose the right to treat the contract as repudiated.

If something happens after you have entered into the contract that makes contractual performance impossible or more onerous, you may be entitled to treat the contract as having been frustrated. The legal doctrine of frustration has a fairly limited application. It usually applies in circumstances where the performance of a contract has become physically or legally impossible due to an intervening event such as the destruction of the subject matter of the contract or a change in the law. Generally speaking, the fact that a contract may have become uneconomic to perform is unlikely to be sufficient to amount to frustration and this is something you should have in mind if another contracting party wants to terminate what for them has become an unprofitable contract.

## WHAT IF EXCLUSIVITY PROVISIONS EXIST?

Where an organisation is locked into a long-term agreement, this could have clear detrimental effects if the relationship is exclusive or there are minimum purchase obligations. An organisation looking to avoid such obligations should as a first point consider whether these obligations can be enforced. This will include analysis of whether the restrictions are enforceable under Article 81 of the EC Treaty (or Chapter 1 of the Competition Act 1998) and whether they are enforceable at common law.

## QUESTION OF RISK

If an organisation is locked into a long-term agreement with enforceable exclusivity undertakings, that is not the end of the matter. Economics may well dictate that it is still better to exit the arrangement or seek to avoid the obligation. Such a step requires considerable caution, and comprehensive legal advice. Here are some key legal points that must be considered:

- can the organisation rely on contractual exclusions to limit potential damages recovery? For example, often "exclusions of consequential loss" clauses are made mutual and an organisation may benefit from such a clause although each clause needs to be looked at on its drafting and facts;
- on the other hand, if an organisation is seeking to rely on contractual exclusions and limits of liability, are these exclusions enforceable under the Unfair Contract Terms Act 1977?
- in a recent House of Lords decision *(Transfield Shipping Inc v Mercator Shipping Inc)*, the court gave an interpretation of the damages rules in Hadley v Baxendale which was highly favourable to the contract breaker;
- can the obligation be avoided without terminating the contract? Generally, exclusivity provisions will be construed *contra proferentem* – against the party relying on them. For example, in an exclusive purchase arrangement, is it possible to route purchases through another group company without breaching the contractual provision?

## WHAT SHOULD I DO?

Before taking any action, careful consideration should be given to the issues highlighted in this article in the context of the commercial circumstances of the deal and the detailed contractual arrangements themselves. Unless the issues are absolutely clear, legal advice should be taken.

We are hosting a seminar on this subject on 31 March 2009, details of which we will be sending to you shortly.

This article is only a brief look at the issues that should be taken into account when considering whether to terminate a contract or how to respond if the other party terminates.

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## FURTHER INFORMATION

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