Get a Termination Right in Your Agreements

By Raymond P. Kolak

Many years ago in my early days as a lawyer in private practice, I was given the job of reviewing a contract for design services for one of our largest corporate clients. I carefully examined the clauses describing the design work to be performed, pricing, terms of payment, default, and all of the other boilerplate. I presented my tentative legal advice to the senior partner who had hired me.

"Ray," he said, "all this is well and good, but you're missing the most important consideration. Design services are like beauty - they're all in the eyes of the beholder. It's almost impossible to state an objective standard for services like that. If the client doesn't like the work product, the most important thing you can do for the client is to give them a clean way out. This contract doesn't do that. You need to give them a right of termination."

I have remembered that advice, and always look for a right of termination in the contracts we write or review for our clients.

Rights of termination are often useful in the real world of performing and administering any contract. If one of the parties fails to do what was promised (say, deliver a load of bricks), the other party has two things on her mind: first, how the failure has hurt her business (how can I keep on schedule in building the house if he doesn't deliver the bricks?), and second, whether the failure will be repeated for future jobs (have I signed on with a lousy brick distributor?) The first consideration, the immediate problem caused by the breach of contract, is urgent, but can usually be solved in some manner. I have found that clients are more concerned about the second consideration, the long-term future of the relationship.

When a party breaches a contract, there is usually not just one big failure to do something, but a pattern of many smaller problems. The bricks were delivered late. Some were the wrong color. Others were damaged. The unit prices were wrong. And so on. None of us is perfect, but there comes a time when all of these problems, while minor if considered one-by-one, become a major headache when viewed in total. So we want out.

If the other party breached the contract, doesn't that mean that we can get out? As with many things in law, it depends on the facts. Contract law provides several legal remedies for breach of contract, among them money damages and discharge of your duties under the contract. Money damages mean that you get a court order awarding you a sum of money to put you in the same position you would have been in had the other side fully performed your contract. Money damages are the default remedy for breach of contract, meaning you get them automatically unless you prove you're entitled to another

remedy. You can get money damages for minor breaches, such as the delivery of 3,933 bricks when 3,934 were ordered.

Discharge of your duties under the contract means that you are released from any further obligation under the contract, and the contract is terminated as far as you are concerned. Discharge of your duties is a much harder remedy to get. To be discharged, you have to show that the other party materially breached the contract.

A material breach means that you did not get substantially what you bargained for under the contract. This is a very subjective test. Delivering one brick short of 3,934 is not a material breach. Delivering all red bricks when black bricks were ordered would be a material breach. The courts consider a number of factors in deciding this, such as when the breach occurs (an early breach is more likely to be considered material), whether the breach can be easily cured, and whether the breach was deliberate.

Suppose the other side is simply late in performing their part of the contract – is that a material breach? In most cases, no. If the other side is merely late, the breach is not material, and so you are not discharged from performing your part of the contract. There are several exceptions to this rule. Contracts for sale of land generally require timely performance, and if your contract states that "time is of the essence", then a failure to timely perform may be a material breach. You may have wondered why "time is of the essence" was put in your contracts. Now you know.

If all this talk about "material breach" has you confused, then you've got my point. Oftentimes, it's hard or just about impossible for your lawyer to tell you with certainty whether the other side has materially breached your contract, allowing you to walk away from it without liability. In the case of the design services contract I worked on as a young lawyer, who could say with certainty that the design firm submitted a bad design, discharging my client from the contract?

That's why a termination right is so important. It gives you the definite and undeniable right to get out of the contract, without any debate on who has breached and whether the breach was material or not. Under most contracts, you will have to pay or compensate the other party for the services performed or product delivered up to the termination date, but at least you can cut your losses and find another vendor to serve you after that.

Termination rights also afford you flexibility to adjust your business relationships to your needs. If you're not certain about the long-term customer demand for your product, then build in a termination right in your contract with your raw material supplier.

We've looked at how termination rights can help you. If they are so useful to you, why would the other side ever agree to them? In some cases, they will agree because the termination rights are mutual. For example, for personal services contracts such as designer or architectural contracts, either party can terminate. The owner simply

pays the designer or architect for all services to the date of termination, and the designer or architect goes on to the next client.

With other contracts, you may not be able to get a termination right without giving up something. For example, if your raw material supplier puts in a special machine and hires extra help to meet your requirements, he's not going to give you an easy out from your contract because he committed to extra costs. In such a case, you might be able to get a termination right if you compensate him for his extra costs by paying a penalty if you exercise your right to terminate. The amount of the penalty should be related to the unamortized portion of his extra costs. As time goes on, the amount of the penalty should decrease as he is able to recoup his extra costs from your orders.

Another way to moderate the effect of a termination right is to make it exerciseable only on written notice, given a good period of time before the effective termination date. The time period might be 7 days, 30 days, or a year, depending on the circumstances. The time period both discourages terminations for minor problems, and allows the other party some time to plan for the oncoming decrease in business.

Getting people to agree to a contract is sometimes a maddening task, and it might seem that a discussion of how the relationship can be terminated before it is even formed is unwise. Bring it up anyway, though, and you might be surprised with what you can get.

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