A large industrial refinery or chemical plant at sunset. The sky is filled with orange and yellow clouds. In the foreground, there are several large, white, cylindrical storage tanks with red railings and ladders. In the background, there are various industrial structures, including tall distillation columns and a complex network of pipes and scaffolding, all illuminated by the warm light of the setting sun.

A GUIDE TO TERMINATION OF LONG TERM CONTRACTS IN THE ENERGY SECTOR

KEY POINTS AND RECENT DEVELOPMENTS

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INTRODUCTION

The recent decline in, future and uncertainty surrounding, the price of oil and gas has caused energy sector companies to look particularly closely at their contractual rights and obligations. A long term contract that was once highly profitable may now be less commercially attractive. For example, buyers under long term offtake agreements such as gas sales agreements may well be able to obtain cheaper gas from other sources and, in those circumstances, will want to renegotiate or terminate existing arrangements. Sellers seeking to recover sunk exploration costs, on the other hand, will want to hold the buyer to its existing bargain.

It is in this context that energy sector companies need to be particularly aware of the law as it relates to the termination of contracts, in order that they can effectively bring to an end commercial arrangements which are no longer economically viable, take action where counterparties are in breach, exert pressure in the context of renegotiations, or resist wrongful termination. Businesses looking to escape their obligations by terminating must take care; terminating a contract when there is no legitimate basis to do so can expose them to significant liability.

We summarise below the key principles of English law as it relates to termination, including new developments, specifically the recent cases of *MSC Mediterranean Shipping v Cottonex Anstalt*, *C&S Associates v Enterprise Insurance*, *Grand China Logistics v Spar Shipping*, *Vinergy International v Richmond Mercantile*, *Globe Motors v TRW Lucas*, *MWB Business Exchange Centres v Rock Advertising*, *Monde Petroleum v WesternZagros* and *Ilkerler Otomotiv v Perkins Engines*.

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KEY TAKEAWAYS

In an economically challenging environment, energy companies often, as part of their commercial strategy, want to terminate long term agreements (or will receive termination notices from their counterparties). This article addresses the main principles of contractual termination under English law in order that energy businesses can understand their rights, how best to exercise those rights in order to achieve their commercial goals, and how to respond to wrongful attempts to terminate.

Key takeaways are:

- i. Consider the basis for terminating the contract – whether a termination stems from a repudiatory breach of contract or a contractual right may affect the level of damages available.
- ii. If seeking to terminate on the basis of a repudiatory breach (rather than a contractual termination provision), ensure that the breach is sufficiently serious to give rise to such an entitlement.
- iii. Check and follow any contractual notice provisions – failing to comply with a contractually agreed process can expose the terminating party to allegations of repudiatory breach and the receiving party can use the terminating party’s non-compliance to resist the termination and/or claim damages.



CONTRACTUAL TERMINATION RIGHTS

Commercial contracts typically include provisions giving the parties the right to terminate in particular circumstances, for example when certain specified breaches of the contract take place, or on the occurrence of force majeure or insolvency events. They may also include provision for “at will” (or “no-fault”) termination for convenience where no breach or relevant event has occurred.

Contracts permitting termination for convenience commonly stipulate a certain notice period or minimum term before which the right cannot be engaged. A party seeking to exercise a right to terminate for convenience should take care to ensure that any provisions on which the right is contingent are satisfied.

Where a contract provides that the parties are entitled to terminate it in certain circumstances, effecting termination will be a question of ensuring that the relevant provision of the contract is engaged and that the correct procedural steps are followed. In particular, it is critical that any notice provisions in the contract are complied with.

For example, the International Association of Petroleum Negotiators’ model form of gas sales agreement allows for early termination in a range of specified circumstances (e.g. prolonged force majeure, material breach of the agreement, insolvency of the other party), but requires the party giving the termination notice to specify the basis for early termination in its termination notice and allows for a cure period after delivery of the notice before the agreement can be terminated.

TERMINATION FOR REPUDIATORY BREACH

In addition to any contractual termination rights, where there has been a serious breach of contract (a so-called “repudiatory breach”), an innocent party has the right both to (i) claim damages to recover any loss suffered; and (ii) elect either to affirm or terminate the contract (even if there is no applicable termination clause that would allow it to do so).

A party can generally terminate a contract for repudiatory breach if:

- (1) there has been a breach of a “condition” of the contract (i.e. a clause that goes to the root of the contract);
- (2) there has been a serious breach of an “intermediate” term, which deprives the other party of substantially the whole of the benefit of the contract; or
- (3) if the other party has renounced the contract by indicating its intention not to perform it in some critical way.

A breach of a mere “warranty” (i.e. a clause that does not go to the root of the contract) entitles the innocent party to claim damages, but does not entitle the innocent party to terminate. As a result, precise analysis of the term of the contract that has been breached is of fundamental importance to assessing whether or not the breach gives rise to a right to terminate.

This is an issue that requires analysis on a case by case basis and the outcome will depend on “*a multi-factorial assessment involving the nature of the contract and the relationship it creates, the nature of the term, the kind and degree of the breach and the consequences of the breach for the injured party*”.²

Businesses should be aware that the parties’ description of the relative importance of a term in a contract will not be determinative. Instead, it is a question of substance and may in some circumstances be determined by the effect of the breach on the parties. For example, although breach of a term classified in the contract as a “condition” will generally result in a repudiatory breach, the term may be broken in a way that does not represent a substantial failure to perform the contract and so does not give rise to a repudiatory breach entitling a party to terminate. However, that does not mean that the categorisation of terms by the parties should be ignored. In the recent case of **GCL v Spar Shipping**,³ the fact that “*charterparties did not make it clear that cl. 11 was to be categorised as a condition*” formed part of the judge’s reasoning that the clause breached should not be categorised as one which, if breached, gave rise to a right to terminate.

² *Ioannis Vasililas v Valdet Januzaj* [2014] EWCA Civ 436 at [53]

³ *Grand China Logistics Holding (Group) Co. Ltd. v Spar Shipping AS* [2016] EWCA Civ 982



Automatic termination following repudiatory breach

As stated above, the general position is that following a repudiatory breach, the innocent party may either affirm or terminate a contract. However, in the recent decision of *MSC Mediterranean Shipping Co v Cottonex Anstalt*,⁴ the Court of Appeal appeared to suggest that this would not always be the case.

MSC Mediterranean Shipping Co (“**MSC**”) had delivered goods to a port on behalf of their owner, Cottonex Anstalt (“**CA**”) but, due to a dispute with the ultimate buyer, there was a delay in MSC’s containers being returned. CA was obliged to pay a fee to MSC which accrued continually throughout the period of delay. CA submitted that it would not be able to return the containers to MSC for the foreseeable future and that this constituted a repudiatory breach that MSC was obliged to accept. MSC argued that this was not the case and that the fee would continue to accrue indefinitely.

The English Court of Appeal held that the commercial purpose of the contract had been frustrated from February 2012, when in commercial terms the containers had been lost and could not be redelivered in the context of the original venture (if at all). Moore-Bick LJ “*[did] not think that the option of affirming the contracts remained open to [MSC] once the adventure had become frustrated, because at that point further performance became impossible, just as it would if [CA] or those for whom it was responsible had caused the containers to be destroyed*”.

The analysis in the **MSC** case suggests that in circumstances where the defaulting party’s future obligations are impossible to fulfil, the innocent party may have no right to affirm the contract and, in effect, it will instead be automatically terminated.

Risk of incorrectly asserting repudiatory breach

Purporting to terminate a contract without the right to do so may result in the terminating party committing a repudiatory breach itself, entitling the other party to elect whether to accept the repudiation and sue for damages for wrongful termination or affirm the contract and insist on continued performance. However, a party

may avoid this outcome if there was an alternative breach which could have given rise to a valid right to terminate the contract at the time the contract was terminated.

In *C&S Associates UK Ltd v Enterprise Insurance Company Plc*,⁵ Enterprise Insurance Company Plc (“**Enterprise**”) purported to terminate its contract with C&S Associates UK Ltd (“**C&S**”) for repudiatory breach. Enterprise alleged that C&S had failed to provide Enterprise with certain files requested as part of an audit and had performed the contract in a generally negligent manner. However, C&S argued that the termination notice provided by Enterprise cited C&S’ alleged refusal to provide the files but made no reference to the alleged negligent performance and that, therefore, Enterprise should not be entitled to rely upon the alleged negligent performance to support its position that C&S was in repudiatory breach of the contract.

The judge found that, while C&S’ failure to provide the files was not a repudiatory breach, its alleged negligence could have been if proven at trial. The judge decided that a party who alleges repudiatory breach and refuses to perform its obligations under the contract, but who gives an incorrect or inadequate reason (or no reason at all) could later justify its decision if there were at the time facts in existence which would have provided a good reason for the termination. In other words, it did not matter that Enterprise had cited invalid reasons for termination in its notice if there were valid reasons extant at the time that it could have relied upon.


The availability of reliance on an alternative reason for termination is subject to the qualification that the alternative reason cannot be relied upon if it would have been capable of being remedied prior to the purported termination. It therefore remains important to be precise and clear about the basis of and grounds for termination.

GIVING NOTICE OF TERMINATION

English law does not require a termination notice to take any particular form unless, as is often the case, this is specifically required by the relevant contract. However, where there are contractual notice mechanics

⁴ *MSC Mediterranean Shipping Company S.A. v Cottonex Anstalt* [2016] EWCA Civ 789

⁵ *C&S Associates UK Ltd v Enterprise Insurance Company Plc* [2015] EWHC 3757



in relation to form or content, the general rule is that these must be strictly complied with to minimise the risk of the termination being ineffective due to a defective termination notice.

That said, defects in the content of a termination notice may not always result in a termination being ineffective. In **Mannai Investment Co Ltd v Eagle Star Assurance**⁶, the House of Lords established the principle that defects in a contractual notice will not necessarily invalidate that notice if the intended effect would be clear to a reasonable recipient. The Court stated that: “*The construction of the notices must be approached objectively. The issue is how a reasonable recipient would have understood the notices. And in considering this question the notices must be construed taking into account the relevant objective contextual scene*”.

While that reasoning may offer a potential lifeline for businesses that have not followed notice provisions precisely, its application is highly fact-dependent and (given the serious risk that the party seeking to terminate may itself be committing a repudiatory breach of contract by reason of the defective notice) it is not a principle that should be relied on too heavily. It is far safer to ensure that any notice complies strictly with the requirements of the contract.

The importance of clearly drafted notice provisions was emphasised in the recent case of **Vinergy International (Pvt) Ltd v Richmond Mercantile Limited FZC**,⁷ in which the court held that a party terminating for repudiatory breach did not need to follow the contractual termination provisions, including notice obligations. A contract for the sale and purchase of bitumen provided six grounds for termination and also expressly preserved the right to terminate for repudiatory breach. One of the six grounds was the “*failure of the other party to observe any of the terms [of the contract] and to remedy the same within the period specified in the notice given by the aggrieved party [...] being a period not less than twenty (20) days*”. The other five grounds contained no notice requirements. Richmond Mercantile terminated the contract for repudiatory breach and gave Vinergy less than 20 days’ notice of their intention to do so. Vinergy alleged that this was insufficient notice and that, as such, Richmond Mercantile was in repudiatory breach of the contract.

⁶ *Mannai Investment Co Ltd v Eagle Star Assurance* [1997] AC 749

⁷ *Vinergy International (Pvt) Ltd v Richmond Mercantile Limited FZC* [2016] EWHC 525 (Comm)

⁸ *Globe Motors v TRW Lucas* [2016] EWCA Civ 396

⁹ *MWB Business Exchange Centres v Rock Advertising* [2016] EWCA Civ 553

The judge held that whether or not a contract’s notice provisions applied to the right to terminate for repudiatory breach was a question of construction. In this case, the 20 day notice requirement only applied to the ground for termination to which it was specifically attached in the contract and not to termination for repudiatory breach under the general law. However, given that a differently worded contract might be construed as applying contractual notice provisions to a termination for repudiatory breach, it remains prudent for a terminating party to follow any contractual notice provisions, while also making clear that the right to terminate for repudiatory breach is being exercised.

No variation, other than in writing, clauses

Two 2016 decisions in **Globe Motors v TRW Lucas**⁸ and **MWB Business Exchange Centres v Rock Advertising**⁹ have added an element of uncertainty to the exercise of seeking to comply with contractual notice provisions. In both cases, the relevant contract contained wording mandating that any variations to the contract be in writing signed by both parties. Both cases saw comments from the Court of Appeal to the effect that such clauses would not necessarily prevent variation of a notice provision by words or conduct. As a result, parties seeking to comply with termination provisions in contracts should have regard, in addition to a contract’s written contents, to any oral variation or variation by conduct of what is required (even where variation other than in writing is prohibited).

In summary, a terminating party should always ensure that its termination notice complies with any contractual requirements and makes clear the basis for termination in order to maximise the prospects of the termination being effective and avoid having to rely on fact-sensitive and uncertain arguments about how the notice should be construed. Conversely, a recipient of a termination notice should review the notice carefully against the contractual provisions in order to analyse whether there may be any basis for either continuing with the contract or treating the purported termination as a repudiatory breach and claiming damages.

IS THERE A GENERAL DUTY OF GOOD FAITH WHEN TERMINATING?

The judgment of the High Court in the 2013 *Yam Seng* case sparked concerned discussion about the existence of a general implied contractual duty in English law to act in good faith, particularly in “relational” contracts that involve long term relationships between the parties in which they make substantial commitments.¹⁰ “Relational” contracts were described as those that “*require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence and may involve expectations of loyalty which are not legislated for in the express terms of the contract, but which are implicit in the parties’ understanding and necessary to give business efficacy to the arrangements*”. The type of contracts into which energy sector businesses routinely enter (joint ventures, long term supply agreements and the like) could easily fall within this category.

However, concerns about the existence of a requirement to act in good faith when exercising contractual termination rights in English law governed agreements now appear to have been allayed. The English High Court last year re-affirmed that a contractual right to terminate can be exercised irrespective of the party’s reasons for doing so. The Court said that “[p]rovided that the contractual conditions ... for the exercise of such a right ... have been satisfied, the party exercising such a right does not have to justify its actions”.¹¹ This was recently confirmed by the Court of Appeal, which rejected an argument that certain terms applying to termination and relating to fair dealing and good faith should be implied into a contract.¹² Lord Justice Longmore stated that the judge in *Yam Seng* was considering the requirements for communication and cooperation in relation to the performance of a contract, and that “*requirements for communication and cooperation in relation to termination would take one into a different realm altogether*”.

Therefore, there is no implied requirement to act in good faith when exercising a contractual termination right. Provided that any conditions set out in the relevant contract have been satisfied, it is open to businesses to exercise contractual termination rights without having to justify their decision or demonstrate good faith.

DAMAGES PAYABLE ON TERMINATION

The availability of damages following the termination of a contract depends on the basis of the termination. An award of damages following a successful claim for repudiatory breach will look to place the innocent party in the same position as it would have been in had the contract been properly performed. This involves quantifying the harm caused by the breach and deducting any benefit the innocent party may have acquired (for instance the loss of a future obligation to pay the defaulting party). Significantly, this measure of damages includes loss of future profits, which can be substantial.

Unlike termination for repudiatory breach, termination pursuant to a contractual right does not give rise to any automatic right to damages for future revenues foregone as a consequence of the early termination. Instead, unless there is an express clause stipulating the available remedy, the innocent party will only be entitled to damages reflecting losses suffered to the date of termination. This important difference highlights again the need to give careful consideration to the basis and grounds for terminating the contract before deciding to terminate.

Where payment security has been provided (for example by a buyer under a gas sales agreement) the contract is likely to provide that, if the agreement is terminated due to the buyer’s default, the seller will be entitled to draw upon the payment security to satisfy amounts that are unpaid and due. Where such a remedy is available to the innocent party it is critical to ensure that the agreement is terminated on grounds that allow the payment security to be utilised.

CONCLUSION

With lower prices for fossil fuels appearing to be the new normal for the immediate future, the potential to terminate contracts which have ceased to provide an attractive commercial proposition is likely to remain on the agenda of energy businesses. However, it is important that businesses consider their termination strategy carefully and do not rush into a decision without properly analysing the legal position. Wrongful termination may give rise to exposure to significant damages.

¹⁰ *Yam Seng Pte Ltd v International Trade Corp* [2013] EWHC 111 (QB)

¹¹ *Monde Petroleum SA v WesternZagros Ltd* [2016] EWHC 1472 at [261]

¹² *Ilkerler Otomotiv Sanayai Ve Ticaret Anonim Sirketi and another v Perkins Engines Company Ltd* [2017] EWCA Civ 183

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