

4 Termination Considerations Before Signing A Contract



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Law360, New York (July 30, 2014, 10:21 AM ET) -- Everyone tends to be optimistic at the beginning of a new business relationship but terminating one can be very costly in terms of time and money if certain questions aren't addressed from the start. For in-house counsel who are under increasing pressure to "get the deal done" and do more with less, it's important to give due consideration to termination provisions when drafting and negotiating commercial agreements.

Addressing termination and clarifying termination provisions upfront can help avoid the expense and wasted time associated with disputes that frequently arise in contract terminations. When negotiating commercial contract agreements, in-house counsel should carefully consider the following four questions related to termination provisions:

1. Is the Right to Terminate Clear and Objective?

Does the agreement include a right to terminate for convenience without any obligations to the other party? If so, a party may decide to use the termination for convenience provision (even if there is a longer notice period than if terminating for breach), to avoid any dispute regarding the basis for termination.

If there is not a termination for convenience provision, are there other obligations that have been objectively breached, such as failure to meet a certain percentage of on-time deliveries during a specified measurement period? If so, does the breaching party have the right to cure such breach, and is the cure period clearly stated? Provisions that may seem objective are not always clear. For example, even if a licensee has failed to achieve agreed upon sales volumes, can the licensee simply pay any unpaid minimum royalties to eliminate the right to terminate?

Do the termination rights apply only to individual orders under an agreement or to the entire

agreement? If the language is not clear, this can be problematic, especially if this is an umbrella agreement with multiple purchase agreements and affiliates operating under the umbrella agreement.

If there are no objective standards for termination, but a terminating party is relying on the general "termination for material breach" provision, a dispute may arise when the agreement is terminated.

2. Does the Other Party Have a Right to Cure the Breach?

If there is a cure period, how does it work? For example, if there is a right to terminate for failure to achieve an on-time delivery rate of at least 95 percent measured over a six-month period, how can such failure be cured? Will the nonbreaching party have to wait another six months to determine if the seller meets the 95 percent requirement over the next six-month period, or will the seller be required to meet the 95 percent requirement during a more limited cure period?

What is the effective date of termination if the provision specifies the termination will not be effective as long as the nonbreaching party is "diligently pursuing" cure of the breach?

Is there a risk that the terminated party will use the cure period to its advantage? For example, the terminated buyer may issue large purchase orders for delivery during an extended period of time beyond the termination date if this is to the buyer's advantage. Continued access to a company's confidential information during the cure period may be a concern in sales representative or distribution arrangements.

3. What are the Risks and Consequences of an Unauthorized Termination?

If there is not an objective right to terminate the agreement, what is the risk in proceeding with the termination? If the agreement does not include a limitation of liability for the terminating party, the terminating party may have significant risk, including payment of consequential damages incurred by the terminated party, if it is ultimately determined that the termination was not permitted under the terms of the agreement.

Are there any laws and regulations that supersede the provisions of the agreement? For example, many countries have laws that apply to terminating sales representatives in their countries, and state laws will apply to terminating certain types of agreements, regardless of the stated governing law.

4. What are the Obligations of the Parties After a Termination?

Are there post-termination obligations that could impact a decision to terminate? A supply agreement may require the seller to provide background intellectual property to the buyer to enable the buyer to continue to produce products if the seller terminates the agreement. There may also be long periods of required transition assistance at terms that are not financially beneficial to the terminating party.

Is the agreement compliant with international or state laws that may apply to payment of commissions or other amounts post-termination?

Does the agreement specify how existing orders will be handled post-termination? Is the completion of the orders essential, or a high priority to either the buyer or the seller? Are there financial risks in terminating even if the termination right is clear? In distribution agreements, the distributor may be collecting annual maintenance payments from customers post-termination that should be remitted to

the manufacturer. Instead of collecting the payments, the distributor may encourage the customer to purchase a competing product. Will either or both parties have noncompete or nonsolicit obligations post-termination? These rights may be impacted by the basis for termination.

Practice Points

- Consider all options for termination.
- Specify whether or not there is an alternative to termination for breach (e.g., can a party choose to pay royalties on unsold products to avoid termination, or is the failure to meet certain minimum sales not considered a breach of the agreement?).
- Watch for "in whole or in part" termination language.
- Before trying to define a "material breach" when the agreement is negotiated, consider which party will benefit from including this definition.
- Consider how the cure period will apply to key provisions of the agreement.
- Be careful about using "diligently pursuing cure" language if certainty regarding termination date is important.
- Limit exercise of certain provisions (e.g., the ability to order large quantities of product) during the cure period if appropriate.
- Determine whether limitations of liability should be mutual and/or should exclude unauthorized terminations.
- Consider the practical business circumstances and relevant dates of termination. For example, terminating a supply agreement for goods sold in the retail market may be insignificant, except if it occurs in the middle of the holiday season.
- Specify how ongoing payments from customers will be collected post-termination.
- Consider issues related to termination in the context of the specific transaction instead of always using the standard termination provisions. Prior to terminating an agreement, think through the potential ramifications and available options in order to limit the risks associated with such termination.

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