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**Draft Chapter
on
Termination of Long Term Contracts for Just Cause**

Revised draft rules with explanatory notes prepared by Professor François Dessemontet
in the light of the discussions of the Working Group at its 3rd session held in Rome, 26-29
May 2008

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I. INTRODUCTION

During its 3rd session in May 2008, the Working Group again debated whether a new provision or set of provisions on the termination of long term contracts for just cause should be introduced in the UNIDROIT Principles on international commercial contracts. As on previous occasions, there was a consensus for continuing work on this topic, with several important observations being made, which may be summarized as follows:

- The residual relationship with the provisions on hardship and contractual provisions on termination contained in individual contracts should be explicitly mentioned
- The definition of the sort of contracts to which termination for just cause might apply should be more precise;
- The exceptional application of termination for just cause as a last resort should be stressed
- The mere loss of confidence by a party towards the other could not be deemed to be a just cause for terminating the contract
- Curial intervention should be mentioned, several participants expressing the wish that only a judgment (or an arbitral award) could declare the contract terminated for just cause.

In his concluding remarks, the Chairman of the Group made the following observations:

- a) there was wide support for asking the Rapporteur to prepare a revised draft in the light of the Group's discussions for examination at its next session;
- b) the scope of the proposed rules should be kept very narrow and as precisely defined as possible.

The following report is to be understood as a follow-up to the main report of 2007 (UNIDROIT 2007 – Study L – Doc. 104) on the same topic. It raises some definitional points before addressing the concerns voiced by the Working Group at its 2008 session and presenting revised draft provisions.

II. DEFINITIONS

As used in the present Report and in the draft provisions, the following words are defined as below:

- a) *long term contract*: a contract for the performance of a recurring, positive obligation; the definition is not identical to the concept of *long term contract* as used in Comment no. 5 to Article 6.2.2 on hardship, which defines long term contracts as “*those where the performance of at least one party extends over a certain period of time*”. Therefore, as the term is used in the present chapter, a contract is not a “long term contract” only because it lasts some years. The main obligation which the party opposing termination of the contract has undertaken must be a recurring, repetitive and positive performance over a period of time. Such is the case for example of joint venture agreements where no joint company has been set up (otherwise the rules on winding up of companies would apply). Further examples are distributorship agreements, licensing agreements, agency agreements. By contrast contracts to which termination for just cause could not be applied are sales contracts or commissioning contracts, or any contract imposing only an abstention such as a contractual prohibition of competition, a contract not to disclose certain data or a lease for fee for 99 years.
- b) *long term duration*: The contract should entail positive performance over a rather long period of time. The Rapporteur takes the view that a duration of *eight years* minimum could be indicated as a “long term” in the official comments to the proposed chapter.
- c) *termination*: an end to the contract with effects for the future, with no restitution of the payment and no retransfer of the goods delivered or the services rendered in the course of performance of the contract;
- d) *revision*: the adaptation of the contract with a view to making it reasonable for the party requesting renegotiation, revision or termination to continue to perform its obligations under the contract; curial intervention is mandatory in order for revision to be binding on both parties;
- e) *just cause*: a serious ground for modifying or ending the contractual relationship because the terminating party cannot be expected in justice, equity and good conscience to continue it until the agreed termination date or until the end of a notice period. The notion of *just cause* is not identical to the notion of *breach of contract*. Nor is it identical to the notion of hardship, *force majeure*, unforeseeability, *clausula rebus sic stantibus*, impossibility, or Act of God. The just cause may or may not relate to the conduct of one of the parties or to events happening outside its sphere of influence. The application of the alleged just cause for termination is residual: it should occur only when all other concepts above have been discussed in a specific case and have been found not to apply.
- f) *compensation*: compensation in the form of damages may include compensation for lost profits, but the sheer admittance that a just cause for terminating the contract exists in a case does not imply that compensation should necessarily be paid for the profits lost by the party unwilling to terminate the contract. The general rule is that termination for just cause does not change the conditions for monetary compensation and financial winding up of the relationship between the parties, nor does it alter the prerequisites for the other remedies that may be available under the contract or the applicable legislation. A judgment should be necessary to define any duty to compensate. Compensation may be ordered by a court for example when the events leading to the termination fall within the sphere of risks of the terminating party.

- g) *sphere of risks*: the type of risks assumed by one or the other party (parties) to the contract under the agreed terms and conditions of the specific contract, including implied terms and conditions.

III. SCOPE OF THE PROVISIONS

A) *Termination for just cause as distinguished from other excuses from performance*

The proposed provisions address extraordinary changes of circumstances which substantially affect a party's ability (or the ability of several parties to a multilateral agreement such as a joint venture with more than two partners) to continue to perform under an unchanged contract.

The proposed provisions do not collide with the force majeure provision of Article 7.1.7 because the force majeure provision addresses a temporary or definitive *impediment to performance* which could not have been expected at the time of the conclusion of the contract. However, the proposed provisions attempt to harmonize the system for applying the remedies by requiring that a notice be given to the party or parties that are not affected by the change of circumstances just as the provision on force majeure does (Art. 7.1.7 (3)).

The proposed provisions do not collide with the hardship provisions of Article 6.2 ff because the test for just cause is not whether the performance of the contract becomes *too onerous* in view of the equilibrium of the contract as in the case of hardship (see Article 6.2.2), but whether the performance can still be expected from the terminating party in spite of the changed circumstances and without having regard to the value of the performance to be received from the other party. The Working Group discussed in 2008 the possibility of broadening the provisions regarding hardship to include the cases for which the provisions on termination for just cause have been proposed. However there was consensus that the hardship provisions are intended to allow continuation of the contract with a modified balance of each party's obligations, while the provisions on termination for just cause aim at allowing one of the parties definitively to end the contractual relationship. This being so, it appeared to the Working Group that a separate set of provisions ought to be proposed.

The proposed provisions do not collide with the initial or subsequent impossibility of performance by the terminating party because impossibility is seen as *absolute (factual or legal) impossibility* of the performance due under the contract, whereas termination for just cause is based on an appraisal of the extraordinary circumstances of the case and a balancing of the interests of both or all parties in the light of which the continuation of the debtor's duty to perform would appear to be an intolerable burden for it.

The proposed provisions do not collide with the *contractual provisions* the parties may have adopted to face the possibility of a change of circumstances, such as the right to terminate the contract in case of a merger of one of the parties with a competitor, the winding up of joint ventures in certain circumstances of fact or law, or the termination on notice of material default. The proposed provisions are not to be seen as yet another remedy for material breach of contract but as supplementing the common will and intent of the parties in cases where the terminating party could not take into account the modification of circumstances at the time of the conclusion of the contract. Parties are free

to provide that termination for just cause will be excluded or to provide for other remedies such as renegotiation or judicial adaptation of the contract only within given parameters. Parties should be advised in the official comments that more detailed contractual provisions are advisable whenever the issue is likely to arise.

B) Scope of the draft provisions as to the contracts to which they should apply

Long term contracts subject to termination for just cause are those which impose an obligation to do something positive, and not those which entail only a duty to abstain from doing something.

The draft provisions address agreements that entail positive duties of cooperation between the parties, such as the exchange of sensitive information, the opening of the books for checking figures on which royalties must be computed, common efforts of research and development for new products or new processes, or joint marketing efforts.

Under some systems of law, those contracts could be characterized as *relational contracts*, because they institute a long term relationship involving some trust and confidence between the parties, without evidencing all the characteristics of a partnership. In other systems of law those contracts could be termed to be concluded *intuitu personae*, that is concluded in consideration of the person or persons undertaking to perform the positive acts that require mutual confidence and trust. However, it is not necessary that a specific confidential relationship existed under the applicable law, such as is sometimes required for the protection of trade secrets. A confidential relationship may be found to be subject to particular requirements that are best explained by the equitable remedies that may be ordered if such a relationship is found to exist, for example the accounting for the profits unduly made by the defendant (as opposed to the profits lost by the claimant which are but an element of the losses suffered). Such stringent tests as are applicable for confidential relationships under the general law of some jurisdictions are not entirely relevant here, although the recognition of those specific relationships is part of the developing body of law on relational contracts.

Further, contracts subject to termination for just cause are those which entail a continuing performance, or a periodical performance, or a repeated performance due after some time has elapsed since the prior performance. The duration of those contracts cannot be fixed in the absolute by giving a number of years, although it is unlikely that a contract of a duration inferior to eight years could benefit from these provisions. The court or the arbitrator will have to consider the investments that have been made or that still have to be made and the economic risks which have been assumed or that should be assumed in the future under the contract the termination for just cause of which is alleged to be admissible.

IV. NOTION OF JUST CAUSE

The draft provision should not be understood as allowing termination for convenience in case of any change of circumstances, or in case of any difficulty which may lead to a diminishing trust and confidence between parties. Rather, the changed circumstances are *significant changes* that have not been taken into account by the parties when apportioning the risks under the contract at the time of the conclusion of the contract. A change of circumstances is significant when it substantially affects a party's ability to rely on a

reciprocal trust and confidence. The change must make the continuation of the contract *intolerable* for the party deciding to terminate the contract.

V. NOTICE OF TERMINATION

The draft provisions require the terminating party to give notice of termination. The purpose of that notice is two-fold.

First, it is necessary to put the party against whom termination is requested that the contract will not longer be performed by the other party. Investments must be avoided in relation to the terminated contract and new investments are to be made in order to seek new business with third parties.

Second, the notice may fix the exact date on which the contract ceased to be binding on the parties, at least for the main obligations. Ancillary obligations such as the duty to keep information confidential, or to refer the case to some alternative dispute resolution body may survive the termination. Similarly, assets related to some bilateral or multilateral contracts that are akin to a partnership or to a joint venture may have to be liquidated and receivables may have to be cashed or guaranteed and this may take some months or some years. However, unless otherwise provided in the contract, the giving of the notice of termination determines the time up to which the profits are to be shared, even if the losses may be apportioned after that date.

Some systems of law require a court to decide on the termination, so that the notice has only a declaratory rather than a constitutive effect. Some other systems do not require the intervention of the court to terminate the contract. The notice then creates a new legal situation and all the rules that may be applicable to such a constitutive act will apply to the notice.

There appears to be a need to specify that the terminating party must react as quickly as possible when the circumstances leading to a possible termination come to his or her knowledge. The terminating party should not speculate to the detriment of the other party with a “wait and see” policy and, at the same time, give notice of termination in an attempt to safeguard its rights. The principle of good faith (Article 1.7) might of course lead to an analogous reasoning, but an express provision would be clearer for all Parties.

A most sensitive issue revolves around the time limit to be fixed for the contract to end. The protection of the other party’s expectations might lead in most cases to set a time limit of three months (or six months in cases of bigger projects). In exceptional circumstances, such as are present in joint ventures for example, the structure of the contract may be such that only certain dates (closing of the accounts) can be taken into consideration. In very particular cases, termination may be immediate. This might happen when several notices to cure a breach have been given to no avail. Then immediate termination remains the only means of stopping a ruinous relationship. In other words, immediate termination will be admitted only where no other solution is conceivable. However, in most cases, an abrupt termination, which is justified in principle but not as taking place immediately, will take effect three or six months later, depending on the ordinary provision for termination in the contract itself, which the court will attempt to follow to the extent possible in fact.

Where the courts have to decide on the justification of terminating the contract, two systems are conceivable:

- i. the operative part of the judgment only states that termination has been justified at the time it was notified to the other party, and then proceeds to determine its financial consequences; or
- ii. the operative part of the judgment changes the legal regime of the parties' relations and terminates the contract. Until the judgment is rendered, parties are still under an obligation to perform the agreement or risk having to pay damages for breach of contract.

The second system involves much more uncertainty for the parties since judicial proceedings may last several years, during which no one knows for sure whether the contract is still alive and deserves to be performed. The following provisions contain an *alternative B* under which the consent of the court is necessary for the contract to be terminated, but the effect of termination will be retroactive to the notice of termination. Therefore, if the terminating party has been right in holding the view that the contract should be terminated, the situation for this party is equivalent to the situation which would arise if the notice of termination has constitutive effects. If this has not been the case, then this party will have to pay damages. However, the other measures this party may have taken, such as entering into contracts with third parties to fill the vacuum left by the intended termination of the original contract between the parties, will not be found invalid.

In *alternative A*, i.e. the notice to terminate entails by itself termination of the contract, the party which wrongly terminates will have to pay damages to the other party, but can maintain the new network of contractual relationships with third parties which the terminating party has thought necessary to build in order to fill the gap created by the termination of the original contract. The worst situation imaginable is certainly the one in which both parties have to perform for years while waiting for the end of the judicial proceedings that may or may not lead to a constitutive judgment of termination.

VI. EFFECT OF TERMINATION.

Termination for just cause entails the end of the contractual relationship for the future only. It has no retroactive effect.

The parties are still under a duty to liquidate their relationship, for example by disclosing the relevant accounts and inventory.

The termination of multilateral contracts raises specific questions because the terminating party cannot force the other parties not to continue the contract. The apparent end of a tripartite joint venture can mark the beginning of a bipartite venture, for example. As the assets are often the same, termination of the contract is more in the nature of an exit by one of the partners. Particular rules are proposed to take into account the ensuing difficulties.

VII. Draft Provisions

**I. NEW ARTICLES TO BE ADDED IN A SECTION 6.3:
TERMINATION OF LONG TERM CONTRACTS FOR JUST CAUSE***Preamble*

Where the performance of a contract becomes intolerable for one of the parties, this party may terminate the contract subject to the following provisions on termination for just cause:

Article 6.3.1

[Termination for just cause]

A contract entered into for a long term or an indefinite period of time and entailing a positive, recurring performance of obligations by at least one of the parties may be terminated for just cause by either party at any time, in exceptional circumstances, with immediate effect if it is so warranted by the circumstances.

Article 6.3.2

[Definition of just cause]

There is a just cause to terminate the contract, where the continuation of the contractual relationship until the agreed term cannot be reasonably expected from the party who terminated the contract, in particular:

- a) in case of change in the circumstances, excluding non-performance and hardship, if continuation of the contract cannot be reasonably expected from the terminating party because of the importance of such change. The importance of the change shall be appraised by taking into account the nature of the contractual relationship and the circumstances of the case;
- b) in case of loss of trust between the parties, if that trust is an important component of the contractual relationship.

**II. NEW ARTICLES TO BE ADDED IN CHAPTER 7, SECTION 3:
TERMINATION****Article 7.3.5A****ALTERNATIVE A**

[Effect of Notice of Termination]

- (1) The notice of termination for just cause effectively terminates the contract for the date which is mentioned therein.
- (2) If a judgment finds that the termination for just cause was not justified, this judgment determines the monetary compensation which is owed to the other party for serving an unjustified notice of termination for just cause. However, such a compensation may be requested only by a party which opposed the termination in a timely fashion and with indication of grounds.

ALTERNATIVE B*[Court ordered Termination]*

- (1) The court may order that a contract is terminated for just cause.
- (2) Once it is definitive and effective, such order will retroact to the date which is mentioned in the notice of termination for just cause.
- (3) If following a purported termination for just cause the court finds that there is no just cause, the court may order monetary compensation for the consequences of the notice of termination and the conduct of the terminating party.

Article 7.3.5B*[Effects of termination for just cause in particular]*

- (1) If termination for just cause is justified due to the conduct of the other party, the terminating party remains entitled to compensation for its losses, including lost profits until ordinary expiry of the contract or until such time when the contract could have been terminated ordinarily or under its own provisions.
- (2) If termination for just cause is justified in case of a change in the circumstances, no compensation is due. However, if the ground for termination lies within the sphere of risks ordinarily assumed by the terminating party, the other party may be entitled to compensation. If the ground for termination lies within the sphere of risks ordinarily assumed by the other party, the terminating party may be entitled to compensation.

Article 7.3.5C*[Effects of termination on multi-party contracts]*

- (1) The termination of a multi-party contract entails the liquidation of all assets and receivables as well as the payment of liabilities or the furnishing of adequate guarantees.
- (2) When only one or some of the parties but not all of them exit the contract or are excluded, the remaining parties are not under an obligation to wind up the relationship, but have to assume all liabilities resulting from the common activities if they do wind it up.
- (3) Unique assets that were acquired or created in pursuance of the contract may be sold or auctioned off among all parties to the contract or to third parties.

TEXT OF THE GERMAN BGB

§ 314 BGB**Kündigung von Dauerschuldverhältnissen aus wichtigem Grund**

(1) Dauerschuldverhältnisse kann jeder Vertragsteil aus wichtigem Grund ohne Einhaltung einer Kündigungsfrist kündigen. Ein wichtiger Grund liegt vor, wenn dem kündigenden Teil unter Berücksichtigung aller Umstände des Einzelfalls und unter Abwägung der beiderseitigen Interessen die Fortsetzung des Vertragsverhältnisses bis zur vereinbarten Beendigung oder bis zum Ablauf einer Kündigungsfrist nicht zugemutet werden kann.

(2) Besteht der wichtige Grund in der Verletzung einer Pflicht aus dem Vertrag, ist die Kündigung erst nach erfolglosem Ablauf einer zur Abhilfe bestimmten Frist oder nach erfolgloser Abmahnung zulässig. § 323 Abs. 2 findet entsprechende Anwendung.

(3) Der Berechtigte kann nur innerhalb einer angemessenen Frist kündigen, nachdem er vom Kündigungsgrund Kenntnis erlangt hat.

(4) Die Berechtigung, Schadensersatz zu verlangen, wird durch die Kündigung nicht ausgeschlossen.

§ 314 Termination, for just cause, of contracts for the performance of a recurring obligation¹

(1) Either party may terminate a contract for the performance of a recurring obligation on notice with immediate effect if there is just cause for doing so. There is a just cause if, having regard to all the circumstances of the specific case and balancing the interests of both parties, the terminating party cannot reasonably be expected to continue the contractual relationship until the agreed termination date or until the end of a notice period.

(2) If the just cause consists in the infringement of a duty under the contract, the contract may be terminated on notice only after a specified period for remedial action has expired or notice of default has been given to no avail. § 323 (2) applies *mutatis mutandis*.

(3) The person entitled may terminate only if he gives notice of termination within a reasonable period after becoming aware of the cause for termination.

(4) The right to claim damages is not precluded by the termination.

¹ Text based on the translation Jeffrey Thomas and Gerhard Dannemann on www.iuscomp.org/gla

ILLUSTRATION

(provided by Professor Lauro Gama Jr.)

In the context of a foreign investment, A, B and C become controlling shareholders of X, each one holding 26% of the total voting shares.

In order to regulate their ownership and voting rights in X, A, B and C execute a shareholders agreement. The agreement provides that, prior to any X's shareholders meeting, A, B, and C must meet and agree upon a common position about the matters included in the shareholders meeting agenda, so that their vote represent a 78% controlling block.

In other words, under the shareholders agreement provision, A, B, and C must reach a previous and binding agreement on how they will vote in block each of the matters listed in the shareholders meeting agenda. The shareholders agreement states that if the parties cannot reach a previous agreement they must cancel the shareholders meeting.

The shareholders agreement is valid for 20 years. After 5 years, C decides to withdraw its investment in X, and sells it in equal parts to A and B, who become the sole parties in the shareholders agreement, each holding 39% of X's total voting shares.

Over time A and B develop completely different views with regard to the company's management and future. As a consequence, they hardly reach any agreement on matters included in the agenda of X's general shareholders meeting, many of which are simply called off.

Thus the shareholders agreement becomes dysfunctional and no important matter can be voted at X's general shareholders meeting.

Note by Professor Gama: According to the proposed provisions on termination of long term contracts for just cause the shareholders agreement can be terminated by either party on the grounds of a supervening lack of trust and co-operation between them, and the ensuing dysfunctional character of the agreement towards the ownership and management of the company.

* * *

In Brazil, the *Superior Tribunal de Justiça*, which is the country's highest court for non-constitutional matters, in a judgment of 13 May 2003, decided a dispute involving parties bound by a shareholders agreement in the same way as the proposed provisions of the UNIDROIT Principles, i.e. due to the supervening lack of *affectio societatis* between the parties to the shareholders agreement, it allowed one of the parties to the agreement to terminate it on the grounds of *just cause*.

Firstly the Court qualified the shareholders agreement as a type of *plurilateral* contract, where the parties' interests aim at common goals and objectives, which distinguishes it from *bilateral* contracts, where parties usually hold contrasting interests.

Therefore the supervening lack of *affectio societatis* within the context of a shareholders agreement authorizes one of the parties to ask for its termination.

In particular, the Court cited a doctrinal authority – Prof. Modesto Carvalhosa – according to which:

“In the context of this contract, typically parassocial and plurilateral, there is no room for unilateral termination. Termination will depend on a just cause, i.e., the lack of affectio societatis, materialized in incompatible conduct (of the shareholder) or divergent will of the parties, or of interpretation of the agreement’s clauses, or any other motive that materializes the dissent, or lack of loyalty as regards the parties to the contract or the company’s interest.”

The Court added that in the case at hand “there is strong evidence of the lack of trust and breach of co-operation and loyalty duties between the parties to the shareholders agreement, which warrants the solution adopted by the inferior Court”.

According to the STJ, termination of the shareholders agreement brings back the parties to the *statu quo ante*, with no retroactive effect, which means that they become individual shareholders not bound by any voting agreement or any other contractual obligation *vis-à-vis* other shareholders.