

[Termination and Cancellation Rights](#)

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According to the UCC and the *Restatement (Second) of Contracts*, a “termination” occurs when either party, pursuant to a power created by agreement or law, puts an end to the contract other than for its breach. A “cancellation,” on the other hand, occurs when either party puts an end to the contract for breach by the other. Nevertheless, the word “termination” is commonly used more generically, and its usage refers to situations where a party cancels due to breach.

This practice note discusses the various ways in which a contract may be terminated, including:

- [Termination for Breach or Nonperformance](#)
- [Termination on Change of Control](#)
- [Termination on Bankruptcy](#)
- [Termination At-Will](#)
- [Termination for Convenience](#)

For more information regarding drafting commercial contracts, see [Commercial Contract Drafting and Review](#). For a checklist of issues and provisions to consider when drafting or reviewing a commercial contract, see [Commercial Contract Drafting and Review Checklist](#).

Termination for Breach or Nonperformance

Only a *material* breach entitles a non-breaching party to terminate a contract and to be discharged of its obligations. A material breach is a significant breach, but it is not always easy to tell whether a breach is material. Materiality is a fact question. The Second Restatement of Contracts spells out the circumstances that are significant in determining whether a breach is material (see section 241), and many jurisdictions rely on its five-prong test. The problem is that these factors are questions of fact—it is not always clear if the breach is sufficiently serious to allow the non-breaching party to walk away from the contract. To instill a greater certainty into the agreement, if possible, it is best to include a definition including a list of the specific circumstances that would be deemed a material breach.

An *anticipatory repudiation* consists of words or conduct that, according to some states, reasonably indicate a rejection of the continuing obligation under the contract, or, according to other states, indicate an absolute and unequivocal refusal to perform or a distinct and positive statement of an inability to do so. An anticipatory repudiation may be seen as the ultimate material breach. A party’s clear statement that he or she will not perform the contract is a total breach that may be treated as an immediate breach discharging the duties of the aggrieved party. Any tender of performance or contractual requirement of notice of termination is eliminated by the repudiation.

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Discerning whether words or conduct constitute an anticipatory repudiation is not always easy. For example, “a demand by one or both parties for more than the contract calls for in the way of counter-performance is not in itself a repudiation nor does it invalidate a plain expression of desire for future performance. However, when under a fair reading it amounts to a statement of intention not to perform except on conditions which go beyond the contract, it becomes a repudiation.” [UCC §2-610](#), Official Comment 2. Under the UCC, the aggrieved party may treat an anticipatory repudiation as an immediate breach, or he or she may prefer to await performance for a reasonable time. [UCC § 2-610 \(b\)](#). In either case, the aggrieved party may “suspend his or her own performance” under the contract [UCC § 2-610 \(c\)](#). If the aggrieved party “awaits [the repudiating party’s] performance beyond a commercially reasonable time [he or she] cannot recover resulting damages which he should have avoided.” [UCC § 2-610](#), Official Comment 1.

The repudiator may *retract* the repudiation by clearly indicating such retraction to the aggrieved party at any time before the repudiator’s performance is due, unless the aggrieved party has materially changed his or her position after the repudiation or otherwise indicated that he or she is treating the repudiation as final. [UCC § 2-611\(1\)](#). An effective retraction reinstates the repudiator’s rights. [UCC § 2-611\(3\)](#). As a strategic point, if the aggrieved party provides the repudiator with an opportunity for retraction for a certain period (a *locus poenitentiae*) and indicates that after that period expires, the aggrieved party will consider the repudiation to be final, the repudiation will automatically become final upon the expiration of that period even though the aggrieved party has not yet changed his or her position in reliance on the repudiation when the retraction period ends. The aggrieved party may shorten or terminate the *locus poenitentiae* at any time, or, even without notifying the repudiator, he or she may materially rely on the repudiation by, for example, making a contract with another party. The retraction period ends with such reliance without notification to the repudiator.

Grounds for insecurity: One party to the contract may have doubts as to whether the other has committed an anticipatory repudiation of the contract. There may be indications of financial problems or other circumstances that create reasonable grounds for insecurity that performance will occur even if the indications do not rise to the level of an anticipatory repudiation. Insolvency alone is not a repudiation of the contract, but it does provide reasonable grounds for insecurity. [Section 2-609 of the UCC](#) allows an obligee (either a seller or buyer who is owed performance) with reasonable grounds for insecurity to suspend its own performance and demand adequate assurances that the obligor will perform. [UCC § 2-609](#). The assurances that performance will be rendered in accordance with the terms of the contract must be received within a reasonable time, not exceeding 30 days. [UCC § 2-609\(4\)](#). Absent such assurances within a reasonable time, not exceeding 30 days, the obligee may treat the contract as having been repudiated.

As a strategic point, whether an obligee has reasonable grounds for insecurity, and whether the assurances provided are adequate, are generally questions of fact determined by commercial standards. [UCC § 2-609\(2\)](#). The UCC provides states that the demand is to be made in writing, [UCC § 2-609\(1\)](#).

Generally, a demand must be clear and unequivocal so that the recipient of the demand is made aware that, *absent assurances, the other party will withhold performance*. An ambiguous communication, or stating that one party is willing to negotiate new terms for the parties’ contract, does not rise to the level of a demand for assurances.

Termination clause: Since not all breaches are so plainly material, and to obviate the uncertainty over whether a breach is material, thereby entitling the non-breaching party to terminate the contract, it is prudent to include a termination clause in the contract.

A termination clause may spell out specific acts or omissions that warrant termination, or it may simply make any uncured breach a cause of termination. For example:

If either party commits a breach of its obligations under this agreement, the other party may terminate this agreement by giving the breaching party at least ten (10) days’ prior notice, except that any such notice will not result in termination if the breaching party cures that breach before the ten (10) day period elapses.

For more clauses and information regarding termination for breach or nonperformance, see [Termination Clauses](#).

Termination on Change of Control

Some executive employment contracts contain a provision, sometimes pejoratively referred to as a “golden parachute,” that spells out the executive’s severance rights in the event he or she is terminated pursuant to a change in control of the company (e.g., a merger or acquisition). Such clauses are intended to give the executive incentive to remain with, and help steer, the company during periods when there is a reasonable possibility of a change in control. A typical “change in control” provision will spell out the following, often in meticulous detail:

- The definition of “Change of Control,” which often includes: a sale of all or substantially all of the assets of the Company; where individuals who, as of the date of the “change of control” contract, constitute the board of directors, cease for any reason to constitute at least a majority of the board; where the stockholders of the company approve a merger or consolidation of the company with any other business entity; where a person or business entity acquires, directly or indirectly, securities of the company representing fifty percent (50%) or more of the total voting power represented by the company's then outstanding voting securities.
- The kinds of “terminations” that trigger the benefits under the “change in control” provision: often, the termination must occur within a certain number of months following the “change in control” event, and must have been “without cause.” Beyond that, there is often no necessity to show that the “change in control” actually led to the termination. To avoid disputes, it is prudent to spell out “cause”: some common examples are terminations for dishonesty, disruptiveness, or disloyalty, or for reasons that engender disrepute of the company.
- The specific severance benefits afforded to an executive who is “terminated” following a “Change of Control.”

Termination on Bankruptcy

Provisions that purport to allow a party to terminate a contract in the event the other party is subject to a voluntary or involuntary filing of bankruptcy, insolvency, or a general assignment for the benefit of creditors, also known as “*ipso facto*” clauses, are generally unenforceable in the event a bankruptcy case is filed. For a termination on bankruptcy clause, see [Ipso Facto Clause](#).

[§ 541\(c\) of the Bankruptcy Code](#) provides that an interest of the debtor (the bankrupt company or person) in property becomes “property of the estate.” [11 USC §541\(c\)](#). Moreover, [11USC § 365\(c\)](#) and [\(e\)\(1\)](#) of the Bankruptcy Code make *ipso facto* clauses in executory contracts (agreements that the parties have not fully performed) unenforceable.

Why Include Ipso Facto Clauses in Contracts?

Why should parties include an *ipso facto* clause in their contract, given that they are generally unenforceable? First, not all insolvencies end up in bankruptcy. Second, the Bankruptcy Code itself allows for exceptions to the rule that *ipso facto* clauses are unenforceable. [11 USC § 365\(c\)\(1\)](#) of the Code states that unless the nondebtor party consents, a “trustee may not assume or assign any executory contract or unexpired lease of the debtor ... if applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession.” [11 USC § 365\(e\)\(2\)](#) states that an *ipso facto* clause is not invalid if “applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties”

Personal Services Exception

Personal services contracts fall into the exception noted in the previous paragraph, consistent with the common law prohibition against the assignment of personal services contracts. Depending on the jurisdiction, this exception has

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been expanded to include contracts that are, by any measure, *not* personal service contracts. While the list varies from jurisdiction to jurisdiction, such contracts include partnership agreements, intellectual property licenses, government contracts, franchise agreements, and limited liability company agreements. When it comes to those sorts of contracts, the non-debtor contracting party may seek relief from the automatic stay to terminate the agreement based on the *ipso facto* clause.

Financial Accommodation Exception

Another exception to the rule that *ipso facto* clauses are unenforceable is contracts “to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.” [11 U.S.C. § 365\(e\)\(2\)\(B\)](#). A “financial accommodation” contract under the meaning of this provision is generally given a narrow construction and is applied to actual extensions of cash or lines of credit rather than to ordinary leases or contracts to provide goods or services.

Intellectual Property Bankruptcy Protection Act

The Intellectual Property Bankruptcy Protection Act prohibits debtor/trustee from rejecting Intellectual Property (IP) licenses to the detriment of licensees. Specifically, [11 USC § 365\(n\)](#) provides that a licensee of IP may elect, after a rejection of the IP license, to (a) treat such contract as terminated (i.e., the licensee can walk away with no further obligations but with no further right to use the IP), or (b) alternatively, can elect to retain all rights, including rights to enforce any exclusivity provisions in the license and related or ancillary agreements, for the duration of the license contract and any extensions thereof permitted by law or by the license. If the licensee elects to retain its rights, then it must make all required royalty payments and must waive any administrative claim for non-performance by the debtor/trustee. Accordingly, [11 USC §§ 365\(n\)](#) and [363\(e\)](#) effectively prevent a debtor/trustee from stripping a licensee’s rights and selling the IP “free and clear” as an unfettered asset.

Are Savings Clauses Ipso Facto Clauses?

A related issue involves so-called “savings clauses” that are widely used when a subsidiary or affiliate company is a guarantor to a loan made to its corporate parent and the guaranty would render such subsidiary/affiliates insolvent. The savings clause purports to “save” the guaranty from being avoided as a fraudulent transfer by automatically reducing or limiting the guaranty obligation to a dollar amount less than the amount that would render the guarantor insolvent. The intent of a savings clause is to defeat the subsidiary/affiliate’s cause of action for fraudulent conveyance under the bankruptcy laws.

Savings clauses raise a host of issues, but one court recently has held that they are invalid and do not insulate the guaranty contracts from fraudulent conveyance vulnerability. The court held that savings clauses are designed to defeat the debtor’s cause of action for fraudulent conveyance, which cause of action is the property of the debtor. Savings clauses are, thus, invalid *ipso facto* clauses conditioned on the insolvency of the debtor and effect a forfeiture, modification, or termination in the debtor’s interest in property. The court held such clauses are “a frontal assault on the protections that [11 USC §548](#) [of the Bankruptcy Code] provides to other creditors [and are] in short, entirely too cute to be enforced.”

Termination At-Will

In the employment setting, absent a contract providing for a term or otherwise imposing a limitation on an employer’s right to discharge an employee (e.g., by limiting discharge to “just cause”), an employer may discharge an employee without liability at any time and for any or no reason. For a termination at-will clause, see [Termination Clauses](#). This rule is so deeply ingrained in American jurisprudence that there is a presumption that employment is at-will.

Employment contracts that vary the at-will presumption may be in writing, verbal, or implied in fact as found by looking to the surrounding facts of the parties’ dealings. A contract implied in fact has the same legal effect as any other contract. Some courts find contracts implied in fact in the employment setting where an employee furnishes

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his or her employer with sufficient additional consideration — that is, a substantial benefit, or a substantial hardship, other than the services which he or she is hired to perform. A common example of additional consideration sufficient to overcome the at-will presumption involves an employee giving up stable employment and moving his or her family to a new city to take a job for which the employee was heavily recruited -- only to be fired without cause just days after the new job started. When the at-will presumption is overcome because of the presence of sufficient additional consideration, the employer may not discharge the employee for a reasonable time.

If the agreement provides for payment of a stated weekly, monthly, or yearly salary, the facts may justify the implication of a contract for that salary period. An agreement for "permanent" employment, however, is at-will.

Employee Handbooks

Numerous cases have focused on the effect of employment manuals or handbooks on the terminable-at-will status of employees. Some courts hold that such manuals are aspirational in nature and do not overcome or displace the at-will presumption unless they clearly express the employer's intention to do just that. (Even if this is the law in the pertinent jurisdiction, it is nevertheless prudent for the employer to include an express provision in the handbook to the effect that the handbook does not create any contractual rights or obligations, and that the employment at issue is at-will.) Other courts hold that to the extent statements in the manuals are deemed to be promises, the employee's continued performance after receiving the manual is construed as an acceptance of the manual's promises, forming a unilateral contract that precludes termination at will.

The enforcement of these promises has induced employers to include provisions in employment manuals and handbooks disclaiming any intention that statements therein should be viewed as legally binding. The enforcement of such disclaimers will often depend upon their clarity and conspicuousness.

Termination for Convenience

If a party wants to reserve for itself the right to terminate a contract for its convenience, it is generally necessary to provide advance notice for the termination or else the contract could be construed as illusory. An example of a termination for convenience provision: “[*Client*] may terminate this agreement for any reason by giving the Vendor at least 30 days’ prior notice.” See [Termination Clauses](#).

After Termination

The time to consider what needs to occur following termination is during the drafting stage. The contract should spell out the parties’ rights and obligations following termination in a separate “Post-Termination” section. Among other things that the contract should specify are the following:

- The contractor should cease performing immediately, and to the extent applicable, terminate any subcontracts;
- It is common and necessary to provide for the return or destruction of confidential information. This is typically included in the contract’s confidentiality provision, and it would be prudent to reference the same in the section dealing with “Post-Termination” rights and duties. An example of such language is as follows: “At the disclosing party’s request, all confidential information, whether in written form, electronically stored or otherwise, and all copies thereof, that is in the possession of the receiving party, including its agents, employees, subcontractors, or representatives, shall [*promptly/immediately/within 5 or some other number of days*] be returned to the disclosing party, or destroyed. If so requested by the disclosing party, the receiving party shall deliver to the disclosing party a certificate executed by one of its duly authorized officers confirming compliance with the obligation to return or destroy all such information.”
- “The contractor shall [*promptly/immediately/within 5 or some other number of days*] vacate the premises and return to the owner all property and equipment belonging to, or furnished or paid for by the owner.” These

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obligations likely need not even be spelled out in express terms in order to be enforceable. A termination notice, by its very nature, tells the party whose activities are being terminated to stop. Fundamental principles of contract law dictate that such party should do those things that, according to reason and justice, it should do in order to carry out the purpose for which the contract was made, and to refrain from doing things that interfere with the purpose of that termination notice. Nevertheless, it is prudent to spell out any specific duties to avoid any argument about them.

- “The contractor shall take all necessary action to protect and preserve the property, to clean up the site, to remove hazards, and to take all other action necessary to leave a safe and healthful site. After those obligations have been accomplished, the contractor shall immediately vacate the site and return all means of access to the site (keys, etc.) to the owner.”
- In the event a migration of services following termination might be necessary, there should be a migration plan in place at the time of contract formation to describe in sufficient detail that the contractor shall cooperate during or perform the migration. The compensation for such service should be established in the initial contract. To ensure the efficiency of the migration, it is prudent to have the contractor agree to utilize the same personnel involved in the contract performance or, at owner’s discretion, to furnish other qualified personnel.

Related Content

Practice Notes

- [Risk Allocation in Commercial Contracts — Termination Rights](#)
- [Commercial Contract Drafting and Review](#)

Annotated Forms

- [Termination Agreement](#)
- [Term Clauses](#)
- [Termination Clauses](#)
- [Term and Termination Clause](#)
- [Ipsa Facto Clause](#)
- [Obligations Upon Termination Clauses](#)

Checklists

- [Commercial Contract Drafting and Review Checklist](#)