

Terminating contracts for "material breach"

Introduction

In our March 2007 newsletter, we examined the English law position in relation to clauses which entitle a party to terminate a contract in the event of a "material breach" by the other party.

In this newsletter, we consider the recent case law that has helped to clarify the meaning of "material breach", and in particular the extent to which it differs from the English law concept of "repudiatory breach".

"Repudiatory breach" in English law

In English law, a breach of a contract by a party will entitle the innocent party to terminate the contract if:

1. the breach is a "repudiatory breach" (and the parties have not excluded the right to terminate upon such a breach); or
2. the parties have expressly provided in the contract that the breach shall give the innocent party the right to terminate the contract.

A full discussion of the first category and what constitutes a "repudiatory breach" under English law is beyond the scope of this newsletter. However, in brief, if the breach is of a clause of the contract that is (or is specified by the parties as being) central to the performance of the contract or the breach substantially deprives the innocent party of the benefits it would have received under the contract, then the breach will most likely be treated by the English courts as a "repudiatory breach".

"Material breach" in English law

By contrast, a clause in a contract that provides that one party may terminate upon the occurrence of a "material breach" by the other party falls within the second category referred to above. Such a clause, however, leaves open the question of whether or not a particular breach is "material".

As we explained in our previous newsletter, despite regularly featuring in commercial contracts, the phrase "material breach" has not been given a definitive, special meaning by the English courts. Historically, the English courts tended to interpret the phrase as being tantamount to "repudiatory breach"¹. However, over the last ten years the English courts have made it clear that "material breach" has a meaning of its own that depends on the circumstances of each individual agreement.

In *National Power Plc v United Gas Co Ltd (1998)*², the English court held that a "material breach" was a breach that has a serious effect on the benefit that the innocent party would have otherwise derived from the contract. The breach involved the alleged failure on the part of National Power to provide information on request. National Power sought to argue that "material" had the same meaning as "repudiatory" (and so the breach would have to result in more than just a "serious effect" on the benefit accruing to United Gas under the contract in order for it to be able to terminate the agreement) but the court rejected this argument.

To ensure that you continue to receive this newsletter, please let us know if you change your contact details (email new details to peter.godwin@herbertsmith.com)

To **unsubscribe** [click here](#).

Should you wish to discuss any of the issues outlined in this newsletter, or any other legal issues that may be relevant to your business, please do not hesitate to contact us.

Contacts



Peter Godwin
Partner
Registered Foreign Lawyer
Tel: +81 3 5412 5412
E: peter.godwin@herbertsmith.com



Dominic Roughton
Partner
Registered Foreign Lawyer
Tel: +81 3 5412 5412
E: dominic.roughton@herbertsmith.com



David Gilmore
Partner
Registered Foreign Lawyer
Tel: +81 3 5412 5412
E: david.gilmore@herbertsmith.com



Gavin Margetson
Senior Solicitor
Tel: +81 3 5412 5412
E: gavin.margetson@herbertsmith.com

¹ *Fortman Holdings Ltd v Modern Holdings* [2001] ECWA Civ 1235, and (in relation to "substantial breach") *Crane Co v Wittenborg A/S* [1999] All ER (D) 1487.

² *National Power Plc v United Gas Co Ltd and another* [1998] All ER (D) 231.

In *Dalkia Utilities Services Plc v Celtech International Ltd (2006)*³, the contract concerned the supply of energy services by Dalkia to the paper manufacturer Celtech, and it provided Dalkia with the right to terminate with immediate effect in the event Celtech was in "material breach of its obligations to pay...". Celtech defaulted on 3 consecutive monthly payment installments out of a total of 174 installments and Dalkia sought to terminate the contract. The English court expressly confirmed that "material breach" does not have the same meaning as "repudiatory breach", and the court went on to hold that the continued and repeated failure to make payments due under the contract in question was "material", and Dalkia was therefore entitled to terminate the contract.

Recent cases

In a succession of cases most recently culminating in *Crosstown Music Company 1, LLC v Rive Droite Music Ltd and others (2009)*⁴, the English courts have confirmed the position reached in *National Power* and *Dalkia*. In *Crosstown*, the court again held that a "material breach" does not necessarily have to be a "repudiatory breach", and that "materiality" simply:

*"connotes the concept of significance, as opposed to triviality, and its materiality has to be measured in its total context."*⁵

So, as far as the materiality of a breach is concerned, it is now clear beyond any doubt that the English courts will treat each case on its own merits, and whether the breach will be deemed to have been sufficiently material to give rise to the entitlement to terminate the contract will depend on factors such as the nature of the breach, the consequences of the breach, the significance of the breach in the context of the contract, the term (and in particular the remaining term) of the contract and the consequences of the innocent party having or not having the right to terminate⁶.

The risks relating to "material breach"

The English courts' interpretation of "material breach", and distinguishing it from the concept from "repudiatory breach", means that English judges will have a considerable amount of discretion when it comes to deciding whether a particular breach is material. Whilst this may be in the interests of fairness and justice (enabling the court to give consideration to a wide variety of factors before determining the appropriate decision in each case), it leaves commercial parties in a position of some uncertainty if a clause simply provides that one party may terminate the agreement if there has been a "material breach" by the other party.

Faced with a breach of an agreement containing such a clause by its counterparty, an innocent party will need to be careful before it decides that the breach is material and attempts to terminate the contract. If the breach is deemed not to be material, then the purported termination by the innocent party may in itself be regarded as being a repudiatory breach of the contract, and the innocent party may find itself on the receiving end of a claim (or counter-claim) from the counterparty for damages arising out of the early termination of the contract⁷. Consequently, parties involved in negotiations regarding the drafting of a termination clause that includes "material breach" as an event of default that entitles a party to declare the contract to be at an end must also be careful.

³ *Dalkia Utilities Services Plc v Celtech International Ltd* [2006] 1 Lloyd's Rep. 599.

⁴ *Crosstown Music Company 1, LLC v Rive Droite Music Ltd and others* [2009] All ER (D) 269.

⁵ *Ibid.* See also *Phoenix Media Ltd v Cobweb Information Ltd* (2000) Unreported; and *Gallaher International Ltd v Tlais Enterprises Ltd* [2008] All ER (D) 273.

⁶ An approach that was advocated in 2000 by the English court in *Phoenix Media Ltd v Cobweb Information Ltd* (2000) Unreported. See also *Glolite Ltd v Jasper Conran Ltd* (1998) The Times 28 January 1998.

⁷ If a party is mistaken as to his right to terminate the contract and attempts to terminate in good faith, the English courts are unlikely to consider such action as amounting to a repudiatory breach. However, if a party pursues weak argument as to termination, then the courts will be less sympathetic (see our March 2007 newsletter and the discussion of *Woodar Investment Development Company v Wimpey Construction Co Ltd* (1980) 1 All ER 571).

Index of previous 12 newsletters

September 2008

"Best" and "Reasonable" Endeavours: Achieving Certainty in Contractual Drafting

October 2008

Developments in Dispute Resolution in India

November 2008

Key Considerations in Dispute Resolution

December 2008

Insolvent Opponents

January 2009

Enforcement of arbitral awards under the New York Convention - recent developments in the UK

February 2009

Japanese Arbitration in the wake of the 2004 reforms

March 2009

Dispute Resolution Clauses: Achieving Certainty in Contractual Drafting

April 2009

The Use of "Without Prejudice Except as to Costs" Offers as a Dispute Resolution Technique

May 2009

Dealing with increased exposure to fraud in the financial downturn

June 2009

The Saudi Legal System

July 2009

Convention on Contracts for the International Sale of Goods ("CISG"): Part II

August 2009

Convention on Contracts for the International Sale of Goods ("CISG"): Part III

One way of reducing the uncertainty is to specify the kind of breaches which the parties agree shall be material breaches (by reference to types of conduct or even by reference to specific clauses in the agreement for which the parties consider any breach must be material). This will reduce the level of uncertainty during the performance of the contract. However, in most complex contractual arrangements, the parties will also wish to have a degree of flexibility over what constitutes materiality and for this reason, even clauses that contain a list of the kinds of conduct that shall amount to material breaches often do so on the basis that the list is non-exhaustive.

Conclusion and Practical Considerations

What constitutes a "material breach" in English law for the purposes of any particular contract will depend on the circumstances of each case, and the English courts will look to the consequences of the breach in order to determine its "materiality". In agreements that use material breach as a trigger for termination rights, situations may arise in which it is unclear whether a particular breach entitles the innocent party to terminate.

Accordingly, when drafting termination provisions that include "material breach" clauses, consideration should be given to the following:

- the fact that "material breach" clauses will not be appropriate for all contracts – the parties must consider whether or not a breach that has only a "serious effect" on the benefit the innocent party was to receive under the contract (but does not substantially deprive the innocent party of such benefit) should result in the innocent party having the option to terminate the contract;
- minimising the uncertainty of "material breach" clauses by specifying the types of conduct that will constitute a "material breach".

The content of this article does not constitute legal advice and should not be relied on as such. Specific advice should be sought about your specific circumstances.

Herbert Smith, Gleiss Lutz and Stibbe are three independent firms that have a formal alliance.

Herbert Smith LLP, 41st Floor, Midtown Tower, 9-7-1 Akasaka, Minato-ku, Tokyo 107-6241.

© Herbert Smith 2009