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Validity of Termination for Convenience Clauses in Requirement Contracts

Short Question

Does a termination for convenience clause in a requirements contract render the contract invalid?

Short Answer

A termination for convenience clause does not per se render a requirements contract invalid. The parties to a requirements contract may resort to the termination for convenience clause only when their expectations undergo a "substantial change." In addition, the termination of a requirements contract for convenience should only be done in good faith and not just to escape contractual obligations.

Discussion

A "requirements contract" is a mutual agreement in which a buyer agrees to purchase all his needs or requirements from a seller in exchange for the seller's promise to supply him. *District of Columbia v. Organization for Envtl. Growth*, 700 A.2d 185, 200 (D.C. 1997). Although requirements contracts lack a promise from the buyer to order a specific amount, consideration is furnished by the buyer's promise to turn to the seller for all such requirements as and when they arise making such contracts enforceable. *Torncello v. United States*, 231 Ct. Cl. 20, 28-29 (Ct. Cl. 1982). Issues regarding termination for convenience clauses in the context of requirements contracts arise primarily in the enforcement of government contracts. See *Torncello*, supra.

Regarding government contracts, when the government contracts with a party with the knowledge that it will not honor the contract, it cannot avoid a breach claim by using the convenience termination clause as a defense. *District of Columbia*, 700 A.2d at 201. See also *T & M Distribs. v. United States*, 185 F.3d 1279, 1284 (D.C. Fed. Cir. 1999). Indeed, "the government may not use the standard termination for convenience clause to dishonor, with impunity, its contractual obligations." *GiniCorp v. Capgemini Gov't Solutions, LLC*, 2007 Va. Cir. LEXIS 5, 4-5 (Va. Cir. Ct. Jan. 2, 2007). In this regard, when a party enters into a requirements contract with the intention of not requiring anything, it becomes an illusory promise. *District of Columbia*, 700 A.2d at 200. This is an *ab initio* breach of the contract as "a route of complete escape vitiates any other consideration furnished and is incompatible with the existence of a contract." *Id.* Therefore, unless there is a change in the circumstances of the bargain or expectation of the parties, parties including the government can not be relieved of liability for breaching their only contractual obligation through use of the termination for convenience procedure. *Id.*

In *Torncello*, 231 Ct. Cl. 20 at 21-22, plaintiff entered into a one year "grounds maintenance and refuse removal contract" to service six Navy family housing projects in the San Diego, California area. The government accepted plaintiff's high priced bid which specified a per call charge of $500 for any call under the pest control item, despite the government's knowledge that cheaper bids were available. *Id.* Due to the high pricing, the Navy did not call plaintiff as required by the contract. *Id.* Despite plaintiff's reduction of charges to $35 per call, the Navy still did not request work from plaintiff and called another competing bidder instead who offered to work at a lower price. *Id.* at 22-23. Plaintiff claimed that the Navy breached the contract by diverting the pest control to others and not requiring it to do any of the pest control work. *Id.* at 23.

Plaintiff brought and lost its claim before the contracting officer and thereafter appealed to the Armed Services Board of Contract Appeals ("ASBCA). *Torncello,* 231 Ct. Cl. 20 at 23. The ASBCA viewed the issue as unimportant because of the government's power in the contract of "constructive termination for convenience." *Id.* The ASBCA was of the view that "[w]hen the Government fails to comply with its contractual obligations under the type of circumstance present here, the contractor is entitled to recover as if the contract had been terminated pursuant to the termination for the convenience provisions of the contract." *Id.* at 24. Moreover, because the contract provided that the Government was liable only to pay those services rendered prior to the effective date of termination and no services in connection with pest control were ordered under the contract, the plaintiff was not entitled to any additional compensation. *Id.*

On appeal to the US Court of Claims challenging the ASBCA decision, plaintiff argued that the doctrine of constructive termination for convenience should not permit the contract in question to be rendered meaningless. *Torncello,* 231 Ct. Cl. 20 at 25. The Court of Claims agreed, noting that because requirements contracts contain the buyer's promise to turn to the seller for all requirements, such contracts are enforceable. *Id.* at 28-29. The Court of Claims further noted that the Navy had agreed to authorize pest control work and acknowledged an estimate that one call would be made per month, which plaintiff agreed to perform. *Id.* at 29. In addition, the Navy accepted plaintiff's bid despite knowing that other lower bids were available and thereafter executed the contract with plaintiff. *Id.* at 48.

The Court of Claims held that the same law which applies to a private person is applicable to the government when it enters into a contract. *Torncello,* 231 Ct. Cl. 20 at 30. The Court noted that it was basic contract law that a power to terminate must be limited in some meaningful way, as measured by the requirement of consideration. *Id*. at 48. As such, the parties may not agree that one or both may walk away from all obligations without

rendering the contract unenforceable. *Id.* at 48. The contract in *Torncello* bound the Navy to give all of its pest control needs at the six housing projects covered to the plaintiff. *Id.* As such, the Court held that termination for convenience was allowed only when "the expectations of the parties had been subjected to a substantial change." *Id.* at 36. That is, where there was a substantial change in the bargain or in the expectations of the parties. *Id.* at 48. Since that did not occur here, the Court of Claims held that the ASBCA erred in allowing constructive termination for convenience and remanded the matter for a determination of damages for breach of contract in favor of plaintiff. *Id.*

In Michigan, the courts do not enforce contracts calling for the purchase or sale of such goods as may be "desired," "ordered" or "wished" and such contracts are distinguishable from the usual output or requirements contracts because the promisor is not bound to deliver or accept any sufficiently definite quantity. *Lorenz Supply Co. v. American Standard, Inc.*, 419 Mich. 610, 631 (Mich. 1984) *citing* MCLS § 440.2306 Practice Commentary, p. 247. Agreeing to a certain minimum quantity enlarges the buyer's duty by depriving the buyer of any option below the minimum. *Barrick Enters. v. 2257 Waterman Operating Co.*, 2008 Mich. App. LEXIS 466, 10 (Mich. Ct. App. Mar. 4, 2008) (Unpublished). The courts consider the minimum estimated quantity in a requirements contract "as a center around which the parties intend the variation to occur." *Plastech Engineered Prods. v. Grand Haven Plastics*, 2005 Mich. App. LEXIS 853, 21 (Mich. Ct. App. 2005) (Unpublished). Moreover, pursuant to the UCC, a contract for sale may measure the quantity by the output of the seller or the requirements of the buyer, measuring such output or requirements as may occur in good faith. *Id.*

In *Plastech*, 2005 Mich. App. LEXIS 853 at 2, both plaintiff Plastech and defendant GHP were competitor-suppliers to JCI, which produced and supplied molded plastic components for the automotive industry. A dispute arose when JCI outsourced control of its

supply contracts to Plastech, which included JCI's purchase orders ("POs") placed with GHP. *Id*. When GHP refused to accept new PO terms and conditions imposed by Plastech, Plastech cancelled all production POs issued to GHP. *Id*. Thereafter, Plastech filed an action against GHP for claim and delivery of production tooling held by GHP and GHP filed a counterclaim alleging, among other claims, breach of contract. *Id*. Plastech moved for summary disposition on the breach of contract claim and the trial court denied the motion. *Id*.

On appeal, GHP argued in support of its breach of contract claims that the POs were requirements contracts which impose a duty on behalf of the parties to act in good faith. *Plastech*, 2005 Mich. App. LEXIS 853 at 18. GHP further argued that this duty of good faith undermined JCI's position that it could, "without reason, warning or liability, terminate a requirements contract at will." *Id*. Conversely, Plastech argued, *inter alia*, that the POs were not requirements contracts because they lacked a minimum quantity requirement. *Id*. at 20.

Citing to *GMC v. Paramount Metal Prods. Co.*, 90 F. Supp. 2d 861 (E.D. Mich 2000), the court noted that under MCL §440.2306 "the party who will determine quantity is required to operate his plant or conduct his business in good faith and according to commercial standards of fair dealing in the trade so that his output or requirements will approximate a reasonably foreseeable figure." *Plastech*, 2005 Mich. App. LEXIS 853 at 19. The court, further citing to *GMC*, noted that if in bad faith or inconsistent with commercial standards of fair dealing a buyer exercises a unilateral right not to purchase or to terminate the purchase orders, the buyer may be subject to liability for breach of contract. *Id*. at 20. In this regard, the court noted that comment 3 to MCL 440.2306 states: "If an estimate of output or requirements is included in the agreement, no quantity unreasonably disproportionate to it may be tendered or demanded. Any minimum or maximum set by the agreement shows a clear limit on the intended elasticity. In similar fashion, the agreed estimate is to be regarded as a center around which the parties intend the variation to occur." *Id*. at 21. As such, the

court held that the fact that the purchase order before it was terminable at will did not automatically preclude a finding that it was a requirements contract. *Id*. at 20. Rather, because the record contained communications between the parties that included estimates of output or requirements, the court held that the POs may constitute requirements contracts and Plastech's unilateral termination of the POs could constitute a breach of contract. *Id*. at 21.

Conclusion

The fact that a requirements contract is terminable at will does not automatically preclude a finding that it is a valid requirements contract. However, a buyer cannot terminate a requirements contract at his convenience. A buyer must act in good faith and consistent with commercial standards. The parties to a contract should resort to the termination for convenience clause only when their expectations undergo such a substantial change in the bargain of the expectations of the parties. Terminating a requirements contract for convenience will result in a breach of the contract and subject the buyer to damages.