

## LITIGATION



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## Key ruling on cancelling open-ended contracts

*There was a ripple of concern among some New Zealand businesses in 2004 when the High Court found eight years was a reasonable notice period for the termination of a long-term oral contract between two companies in the waste paper business. These concerns were allayed when the matter came before the Court of Appeal in 2006 and now, following the release of the Supreme Court's judgment earlier this month, finally can be put to rest.*

This is an important judgment for people in business as contracts are often entered into informally, for example, through the exchange of letters or emails, or sometimes even as a result of discussions only. In such circumstances, the contract will normally be open-ended (i.e. it will not have a fixed term), and will not contain express provisions on how it is to be terminated. Even some formal contracts do not address these important issues.

The Supreme Court, in its decision in *Paper Reclaim Limited v Aotearoa International Limited* of 1 May 2007, has confirmed contracts of this sort can be terminated upon the giving of "reasonable" notice. The court also provided guidance on how a "reasonable" notice period is to be determined, and set limits on the time period

over which a party in receipt of a cancellation notice can claim damages from the cancelling party.

The decision in *Paper Reclaim* is, therefore, a useful reminder of the practical considerations that must be taken into account when seeking to bring to an end an open-ended contractual arrangement. Such a contract will usually contain an implied term that it can be terminated on reasonable notice. That period of notice will vary from case to case, and businesses must take into account the need for the other party to:

- carry out and conclude existing commitments;
- bring any current negotiations on the table to fruition;
- wind down matters in an orderly way;
- have an opportunity to explore the market for alternative opportunities; and
- obtain the fruits of any "extraordinary expenditure" carried out under the agreement.

Importantly, in setting out these practical considerations, the Supreme Court rejected the suggestion that sufficient time must be given to enable the non-cancelling party to establish a similar, alternative arrangement to that operating under the relevant contract, which had led the High Court to the rather

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startling conclusion that an eight-year notice period was reasonable in the circumstances.

#### The facts in *Paper Reclaim*

Aotearoa International Limited (Aotearoa) and Paper Reclaim Limited (Paper Reclaim) were parties to a long standing contract under which Aotearoa exported Paper Reclaim’s waste paper on an exclusive basis. Aotearoa sued Paper Reclaim following Paper Reclaim’s attempt to summarily terminate the arrangements between them.

The High Court had determined the work carried out by Aotearoa for Paper Reclaim was pursuant to an oral contract made at a meeting of representatives of the two companies in or about 1985. Nearly 20 years later, Paper Reclaim wished to end the arrangements. In February 2001, Paper Reclaim wrote to Aotearoa stating it did not believe any contract existed between them and, as a result, arrangements were at an end.

Fifteen months later Aotearoa gave a notice of cancellation of the contract it believed to exist between them on the basis that Paper Reclaim’s earlier letter had itself amounted to an unlawful rejection of the contract.

The High Court held there was a contract between them, and the parties agreed that such a contract could be terminated on reasonable notice. They disagreed, however, over what constituted “reasonable” notice of termination.

#### The lower courts’ decisions

In arriving at an eight-year notice period, the High Court had accepted the proposition that, in fixing the appropriate period of notice, the emphasis should be on the time necessary for the non-cancelling party to create a replacement trading situation. The Court of Appeal disagreed, and stated the matters relevant to determining the notice period were the carrying out of existing commitments, giving notice of the termination

of supply to existing customers, bringing current negotiations to fruition and, where appropriate, obtaining the fruits of any “extraordinary expenditure or effort carried out within the scope of the agreement”. The Court of Appeal noted the first three factors would point to a short notice period, and in this case, the last factor (“extraordinary expenditure”) was not relevant. On this basis, the Court of Appeal concluded that 12 months was a reasonable period of notice.

#### The Supreme Court’s decision

The Supreme Court agreed with the Court of Appeal’s observations, and in particular, that the period of notice should not be longer than 12 months. In doing so, it rejected the trial judge’s approach that the period must be sufficient to enable the party on the receiving end of a cancellation notice to build up a business comparable to that which it carried out under the contract in question. Taking a pragmatic approach, the court noted that if a contracting party desired such a situation, then that contracting party should have taken steps to ensure it had a formal contractual arrangement in place which contained sufficient notice periods and termination provisions to enable it to do so.

On this basis, the Supreme Court agreed with the Court of Appeal that a period of 12 months would have given Aotearoa “sufficient breathing space” in which to take stock of its situation, complete ongoing work under the contract and to explore any opportunities which might exist for it in the waste paper market or other lines of business.

#### The question of damages

The Supreme Court took a different approach, however, to the Court of Appeal on the question of over what period Aotearoa could claim damages from Paper Reclaim for Paper Reclaim’s unlawful termination of the contract.

## “The decision highlights the need to take care when seeking to cancel an open-ended contract...”

The period over which damages may be claimed will often be important in a falling or rising market, which may have a significant impact on the amount of money able to be claimed. The Court of Appeal had held that the contract only came to an end as of 3 May 2002, i.e. when Aotearoa (finally) accepted Paper Reclaim's rejection. Thus, on the Court of Appeal's analysis, the 12-month period ran from May 2002.

The Supreme Court disagreed. It stated the 12-month period for calculating damages ran from February 2001, the date of Paper Reclaim's original, but invalid, termination letter. The Supreme Court reiterated earlier authority which makes it clear that, in the case where a notice of termination has been given invalidly, it should be assumed that a valid notice of termination would have been given by the party wanting to cancel a contract “at the earliest possible date”. On this basis, the Supreme Court concluded:

“In accordance with this principle, therefore, damages for Paper Reclaim's repudiatory breach of contract should be assessed on the assumption that, if it had adhered to the contract, it would have chosen to give twelve months notice on 2 February 2001, and that the contract would have terminated upon expiry of that period.”

Thus, the correction period over which damages could run was February 2001 to February 2002.

### Business implications

The decision highlights the need to take care when seeking to cancel an open-ended contract, or may give further ammunition if on the receiving end of an unwanted notice of cancellation of such a contract.

For a contract which has been on-foot for any reasonable length of time (for example, a period of five or more years), it is probably safe to assume a period of less than four to six months' notice of termination would likely

be considered too short and, therefore, unreasonable.

As noted above, what is reasonable will of course depend on the factual circumstances in each individual case. However, business people should give a reasonably generous period of notice, so the party receiving the quite often unexpected and unwanted cancellation notice will have little room to challenge the decision to terminate.

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