MELBOURNE FORUM ON EWL – 16 APRIL 2014

CAN GOVERNMENTS BREAK CONTRACTS?

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The usual consequence

Anybody can break a contract. This usually provides the other party with a legally enforceable remedy. In most cases the remedy is compensatory damages. This applies to government. But government may get special treatment as described in these notes.

Type of contract

Government contracts are usually made under the government's executive power. That is, there is no legislation needed. Large infrastructure contracts, on the other hand, are sometimes backed by legislation. An example is CityLink which is backed by the *Melbourne City Link Act 1995* (Vic). The relevance of this is that if the contract is backed by legislation, it will need further legislation to make any changes to it (unless the original legislation provides otherwise), including terminating the contract. See below under **Legislative termination**.

The dilemma

The law has recognised that there is a basic tension between the binding nature of contracts and the need for governments to be able to govern. If a government is hampered or curtailed in governing – for example implementing a new policy or responding to a crisis – the law may recognise that the government can break the contract without the usual consequence of having to pay damages.

The doctrine of executive necessity

The common law (judge-made law) recognised in wartime United Kingdom that the dilemma had to be resolved in favour of the government. The government could not be inhibited by contracts in its conduct of the war effort. This principle – the doctrine of executive necessity – has been recognised as part of the law of Australia by the High Court: *Ansett Transport Industries (Operations) Pty Ltd v Commonwealth* (1977) 139 CLR 54.

The case law on this principle is very sparse. Its boundaries are not at all clear. It does not give the government carte blanche to break contracts. I have suggested that it can be invoked by government when there is a high-level change of policy or a major re-organisation of budgetary priorities.[1]

An example may be when a new administration takes over after an election and the new incumbent was elected on a platform that included the policy that necessitates breaking contracts. Normally a mere change of government would not justify the breaking of contracts entered into by the previous administration. The contract is with the body politic – the State of Victoria. The State cannot just

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[1] Seddon, N, *Government Contracts: Federal, State and Local* (5 ed 2013) para 5.3.

break a contract because those in control would like to get rid of the contract entered into by the previous administration. But possibly, a new policy could justify that, particularly if the new administration had specifically campaigned on the new policy.

This is speculative because there is very little case law. A recent New South Wales case doubted whether a change of policy would justify a government in breaking a contract (and the judge specifically criticised my suggestion). The case is *NSW Rifle Association Inc v Commonwealth* [2012] NSWSC 818. The Commonwealth owns land at Maroubra in Sydney. The land is used for a shooting range by the NSW Rifle Association under a licence from the Commonwealth. The Commonwealth decided that it wanted to transfer the land to the State so that it could be used for public amenity. This necessitated the breaking of the licence agreement. The judge held that the Commonwealth could not break the agreement on the basis of executive necessity.

Executive necessity is therefore a very uncertain basis for a government deciding to break a contract.

Termination for convenience

The Commonwealth routinely includes a clause in its contracts that enables the government to terminate “for convenience”. (The licence contract for the Rifle Association did not include such a clause!) The inclusion of this clause is a reflection of the common law doctrine of executive necessity and attempts to provide greater certainty than is provided by the common law doctrine. The reason the clause is used is to enable the government to terminate if there is a change of policy or budgetary allocation. The clause is an improvement on the doctrine of executive necessity because the clause usually includes a limited compensation mechanism.

Again, the boundaries of the legitimate use of a termination for convenience clause are not certain because there is very little case law. A Victorian case has made it clear that the clause must be exercised in good faith.[2] In my view, if such a clause were included in an infrastructure contract, it would be a legitimate use of the clause if a new administration has been voted in after an election and, in particular, if the new administration had said during the election campaign that it would discontinue the infrastructure project.

This basis for termination of course depends on a specific clause allowing termination for convenience.

Legislative termination

It is possible for Parliament to pass legislation that shuts down an existing contract. This idea stems from the supremacy of Parliament.

This is a possibility whether the contract is made simply under the executive power or is backed by legislation. Parliament can always amend an earlier Act by a later Act.

In Australia, in three jurisdictions such legislation can be challenged. Under the Commonwealth Constitution and in the two Commonwealth Acts that established the Northern Territory and the

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[2] *Kellogg, Brown & Root Pty Ltd v Australian Aerospace Ltd* [2007] VSC 200.

Australian Capital Territory, there is a section that prohibits the acquisition of property other than on just terms. Legislation can be declared as unconstitutional (invalid) if it infringes the section.

How can this constitutional protection apply to contracts? It can apply because lawyers have a broad view of what constitutes "property". A contract right can be regarded as property (mysteriously called a "chose in action"). If that right is taken away, this could constitute an acquisition of property and, unless just terms (adequate compensation) are provided under the legislation, the legislation can be invalid.

State constitutions, such as the Victorian Constitution, do not include a just terms section. Importantly, for the present debate, the Victorian Parliament is not constitutionally inhibited in passing legislation that could amount to an acquisition of property other than on just terms. In short, legislation can shut down a government contract.

The High Court has verified that a State government is not prevented from passing such legislation. The case is *Durham Holdings Pty Ltd v New South Wales* (2001) 205 CLR 399. In that case the New South Wales Parliament passed an act to acquire coal assets. The Act did provide for compensation but the company considered that it was inadequate. The High Court held that the legislation was valid. A State Parliament has full power to make laws for the "peace order and good government" of the State and is not required to compensate if legislation is passed which adversely affects a citizen or a company.

There have been other examples of State governments passing legislation to override contracts. One such example was the *Aurukun Associates Agreement Repeal Act 2004* (Qld) which cancelled two mining leases to a company called Aluminium Pechiney Holdings Pty. Ltd. I understand something similar happened in connection with Kakadu and Fraser Island but have not been able to track down the details.

The legal position is one thing …

The label given to the possibility of a government changing directions, with adverse consequences to business interests, is "sovereign risk". This risk is inherent in any dealings with government. It is a risk that contractors have to factor in when bidding for government work. It probably causes at least some government projects to be more expensive.

Victoria used to attempt to allay fears of sovereign risk in its publications. In Partnerships Victoria, "Guidance Material - Risk Allocation and Contractual Issues – a guide" (June 2001) Chapter 15 sovereign risk was specifically addressed with a view to minimising it so far as possible. I have not been able to find any similar statement in current Partnerships Victoria publications.

It is possible to include clauses in a PPP contract that cater for the possibility of sovereign risk. But, ultimately, such clauses could be overridden by legislation because of the plenary power of Parliament. It would obviously be very controversial for a government to override a contract through legislation, particularly if the contract specifically provided for that possibility and promised compensation.

Probably an inhibiting factor is the possibility of a government's credit rating being adversely affected by the government shutting down a major project. Governments are very concerned about their credit ratings. They directly affect the cost of borrowing. The Kennett government was intent on lifting Victoria's credit rating when it came to power and it succeeded in that objective. I do not know how credit rating agencies operate. It is not a sign of bad financial management to shut down a major project because the popular will prevailed. But credit rating agencies may see it differently.