

THE STRATEGIC BREACH OF CONTRACT

Some months back, I wrote an article on the importance of contracts in our everyday lives. One area that was excluded from that discussion was if and when terminating a contract prior to full performance was justified even though it could result in a claim for breach. A party to a contract expects to reap the benefits from the other's performance be it the payment of money, services rendered, materials supplied or some other form of performance. Through contracts, we allocate our scarce and limited resources today (such as time and money) to "buy" a reasonable degree of certainty in our affairs of tomorrow. This allocation of resources and expectations of stability are the fundamental principles underlying the law of contracts and the basis upon which the legal system will enforce the intent of the parties.

Contracting is a form of risk allocation and unfortunately that risk sometimes turns against us. So what happens when a contract that was once an asset becomes a liability and we watch our scarce resources diminish at an ever quickening pace? We have essentially three options: (i) continue performance under the contract despite the losses; (ii) unilaterally terminate our performance or (iii) attempt to negotiate a termination or modification with the other party.

Continuing performance under the contract may be a viable option. If you have diversified operations, a loss in one area could be an asset in another. Losses may potentially be deducted from income or taken as a credit for tax purposes. Also, the goodwill associated with the contract may be more valuable than the losses (such as when the contract is between a small business and its primary customer). Nevertheless, before deciding to continue performance several factors must be evaluated the two most important of which are the duration remaining on the contract and the estimated losses to be suffered. Short term duration and limited losses may be acceptable while long term and unknown are probably too risky to accept.

A current trend (as evidenced by the mortgage industry) is for a party to seek mutual termination or modification of a non-productive contract. Although benefits arise from the implementation of these options, your losses are probably resulting in significant gains for the other party. In such cases, the other party has minimal incentive to terminate or modify the contract. Thus, although requesting termination or modification is an option, and should be pursued, it is often the least acceptable option and routinely declined by the other party.

Finally, there are times when the best option is to cease performance under a contract. After consideration of all relevant factors, if it is evident that continuing performance will yield more losses than would occur from a breach, then by all means, breach the contract. For example, if performance of an existing contract will result in a loss, but performance under a substitute contract would yield profits substantially in excess of that loss, then a financial incentive exist to breach the existing contract, to perform the substitute contract and to use those proceeds to pay any damages resulting from the breach. This is known as a "strategic breach of contract." On balance, terminating the existing contract yields a positive result even though damages may have to be paid. In fact, our legal system anticipates that parties will breach their contracts and has implemented theories for calculating damages. Damages awarded are essentially computed in one of two ways: (i) the amount the non-breaching party incurs to complete the job or (ii) the reduction in the value between what the parties contracted for and what the non-breaching party received.

The consequences of a strategic breach of contract are calculable and generally fixed. However, no situation presents an identical set of facts to any other so each must be evaluated individually. It is best to seek independent advice from your trusted professionals before taking action. However, always bear in mind that strategically breaching a contract is an acceptable alternative to performance provided that due consideration is given to all relevant factors. An informed decision almost always results in the best decision and that best decision may be to walk away. Contracts are, after all, just business.