

Efficient Breach of Contract: If the Cost to Comply with a Contract Exceeds the Cost to Break It, What Can Be Done?

James A. Rubenstein
Spring 2014 Firm Newsletter
04.11.2014

At times, there may be ample legal justification to cancel a business contract. The product ordered does not meet the requirements of the contract. The buyer is not paying amounts when due. There is a dispute about the meaning of an important contract clause. At other times, the contract may be going along just fine, but at some point, it just becomes a bad deal for one of the parties. At that point, one may want to consider an “efficient breach” by canceling or ignoring the contract, even if the other party has not defaulted.

Consider these examples:

1. A tenant under a long-term real estate lease downsizes its business and no longer needs all of the space. There is nothing wrong with the lease, the landlord is a good one, and the rent would be reasonable if the tenant needed all of the space.
2. A toy company has a long-term contract to buy ping pong balls from a manufacturer at a pre-determined price, but the bottom has fallen out of the ping pong ball market. Ping pong balls are available on the open market for a much lower price. If the toy company continues to purchase ping pong balls under the contract, its cost to make ping pong ball launchers becomes too high to be profitable.
3. A real estate owner finds that the value of its warehouse property has fallen below the amount of the mortgage debt on the property, and cash flow is becoming a problem.

Each example illustrates circumstances under which a party may have a strong economic incentive to breach a contract. If the contracts in these examples do not provide for early termination under the circumstances, an efficient breach may provide relief.

Considerations

The “efficient breach” concept is based on economic theory: If party A is better off breaching the contract and paying damages to party B, both parties, considered as one economic unit, will be in the same, and perhaps in better, financial condition than they would have been had both parties fully performed under the contract. Under the theory, the party with the economic burden, party A, actually should breach the contract. As a result, the overall economy, will be better off.



When a contract no longer makes economic sense, one must carefully evaluate whether the benefits of an efficient breach outweigh the costs. Here are the top four factors to consider when contemplating an efficient breach:

1. **Understand the Contract:** Learn the rights and duties of both parties upon a premature termination of the contract. Are there defaults by the other party that would justify a termination for cause? Do any special damage provisions apply? Evaluate the strong and weak points in the contract that would give either party leverage.
2. **Practical Effect:** Analyze the practical effect of an efficient breach on the non-breaching party. Even if adequate damages are paid, will the non-breaching party need to lay off employees or close a plant? Thinking about this in advance will help in assessing the reaction of the other party, and may help avoid future litigation.
3. **Renegotiation:** Consider attempting to renegotiate the contract. The other party may be willing to renegotiate rather than lose the relationship entirely or become embroiled in expensive, unpredictable litigation.
4. **Timing:** Provide sufficient notice before breaching a contract. This may help minimize the non-breaching party's damages. For example, if the breaching party is a supplier of a key part to a manufacturer, adequate notice may help the non-breaching party avoid shutting down production before it can find an alternate source of replacement parts.

Economic Reality

When litigation costs and attorney fees get involved, the cost of an efficient breach may outweigh the economic benefits, no matter who wins the case. In addition, many contracts contain liquidated damages clauses that fix the amount of damages in the event of breach that may substantially exceed actual damages. In other circumstances, the non-breaching party may be able to obtain a court order requiring the breaching party to continue with specific performance of the contract, despite adverse economic consequences.

Although efficient breach sounds reasonable in theory, it can lead to messy and expensive real-world consequences unless one proceeds with caution and a thorough appreciation of the risks. In an extreme case, in 2012, a New Mexico court imposed \$40 million in punitive damages against the party attempting an efficient breach of a contract to sell dental equipment. In part, the court imposed the damages because it found that the breaching party was trying to put the equipment buyer out of business.

In another case out of New Mexico, decided in 2011 with the intriguing title "*Two Old Hippies, LLC v. Catch the Bus, LLC*," the judge wrote in support of the policy of efficient breach that a party should not be discouraged from "walking away from a contract when it no longer profits." Despite this, the court awarded the two old hippies a small penalty, together with their costs and attorney fees.

In the example of the tenant, above, one factor to consider is that lease terms vary greatly on how damages for lost future rent are calculated. In addition, market conditions, especially the time and expense to find a replacement tenant, may also affect the damages that a landlord may claim under the lease.

For most goods in commerce, such as a fulfillment contract for ping pong balls, damages are measured in accordance with the terms of the contract or, if the contract does not address the measure of damages, the Uniform Commercial Code (“UCC”). Under the UCC, the primary factors in calculating damages include the cost to the non-breaching party to obtain alternate performance and a comparison of the market price to the contract price.

The third example involving the warehouse property illustrates a common problem caused by the collapse in both commercial and residential real estate values since 2008. A one-sided attempt by a borrower to walk away from a mortgage debt will have little benefit to the borrower unless the mortgage lender’s remedies are limited, either under state law or by agreement. Otherwise, the borrower may lose the property to foreclosure and still be required to pay any amount of the debt not satisfied by the foreclosure sale. The closer the mortgage balance is to the actual value, the less likely that the borrower will be exposed to a deficiency judgment. The impact of foreclosure on the borrower’s credit rating may make future loans harder and more expensive to get, however.

Finally, it bears noting that many courts and legal scholars criticize the efficient breach theory based on the principle that one should not break a promise. In the case of the ping pong ball contract, suppose that the manufacturer is a small shop with a few long-time employees that is almost wholly dependent on the contract for its ongoing business. The cold application of the economic theory of efficient breach may not get a good reception from either the manufacturer or any court that may be asked to rule on the issues, such as the appropriate remedy under the circumstances.

Conclusion

Efficient breach is a good economic theory. The problems arise in the real world of commerce and litigation. In general, it is best to anticipate that the aggrieved party will take an aggressive approach to claiming damages. Before initiating an efficient breach of a contract, the practical economic impacts and the real-world reaction of the other party should be thoroughly analyzed.

Practice Areas

Business Law

Litigation

Financial Services