

What Constitutes a Material Breach of Contract?

By Paul A. Rianda, Esq.

Most Agent Agreements provide for the sales agent to lose its residual upon a “material breach” of the Agent Agreement. In this article I will examine the definition of a “material breach” and also provide a number of examples to help define what constitutes a material breach of a contract.

Definition of Material Breach:

Any breach of a contract which causes an injury to the other party gives the injured party a right to seek damages as compensation. What this means is that even if the breach is trivial, the injured party can sue the other party, or demand compensation, to pay for any damages. For instance, a sales agent who has been underpaid on its residuals, even if the amount is less than \$100, is entitled to receive the deficit in its residuals if it chooses to pursue such a claim.

Although any claim for damages may allow a party to move forward to recover damages as compensation, a higher threshold is required to be met before a party can actually cancel the contract based upon a breach of contract. If the breach is trivial or does not go to an important provision of the Agent Agreement, the aggrieved party cannot terminate the contract. The breach must be a “material breach” in order to allow a party to terminate the contract. What constitutes a material breach depends upon the seriousness of the breach and the probability that the injured party can obtain what it bargained for under the contract.

Breach Early in The Contract Term:

Even a slight breach of contract at the outset of a contract may justify termination of the entire agreement. This is because a breach so early in a relationship between the parties tends to indicate that in the future it is likely that there will be continued difficulties in a relationship. In addition, since the contract is new, the injury to the parties if the contract is terminated is lessened because the parties do not have a long term investment in the relationship.

For example, if a sales agent contracted with an ISO and within the first month the sales agent submitted a fraudulent application to the ISO, the ISO would likely be justified in immediately canceling the Agent Agreement. The reason is that given the newness of the relationship, any such fraudulent application could be indicative of future attempts of fraud by the sales agent. In addition, the sales agent and the ISO would not have a large book of business that would need to be protected by the continuation of the contract.

However, after considerable performance under the contract, a slight breach which does not go to the “root” of the contract will not justify termination. Using the same example, if a sales agent provided a fraudulent application to an ISO two years into their Agent Agreement, and had submitted thousands of other applications, it is unlikely that this one single act would constitute grounds for termination of the contract by the ISO.

Exclusivity provisions in an Agent Agreement are subject to their own specific requirements that are much more stringently applied than other provisions in an Agent Agreement. As to an exclusivity provision, even a slight breach of such a provision can allow for a termination of the Agent Agreement. Many ISOs in the past, and still to this date, require their sales agents to be exclusive sales representatives for said ISO. The law holds that even submitting one application to an ISO by a sales agent who has an exclusive arrangement with another ISO, could constitute a material breach of an Agent Agreement.

Identifying Acts that Constitute A Material Breach:

Many Agent Agreements identify specific acts that constitute a material breach of the agreement. The provisions in the contract that are often identified as constituting a material breach include, but are not limited to, solicitation of merchants to another processor, violation of the Visa and MasterCard rules, fraudulent conduct and violation of exclusivity provisions. Sales agents would be well advised to review their Agent Agreements to ensure that they do not violate any of the specific prohibitions that are identified as a material breach.

The danger of committing a “material breach” to a sales agent is that such a breach will allow the ISO to cease paying the agent its residuals under the Agent Agreement. Even if the breach does not cause the ISO monetary damages, such as a violation of the Visa and MasterCard rules where no fine is imposed, an ISO arguably has the right to cancel a sales agent’s residual.

For this reason, it is imperative that in the Agent Agreement the sales agent clearly identifies the specific actions that could cause it to lose its residual. This is in contrast to just including a blanket provision that states the sales agent loses its residual for a material breach of the agreement. Having such a broad material breach provision in an agreement generally allows an ISO too much latitude in determining when and if it can cancel the residual.

The sales agent is better protected if it lists the items that could cause it to lose its residual. In negotiating an Agent Agreement, a sales agent can typically negotiate that it would only lose its residuals if it moved merchants, engaged in fraudulent conduct or engaged in other conduct that caused monetary damage to the ISO. Even if the ISO does sustain a monetary loss, it is prudent for a sales agent to put a term into the Agent Agreement allowing the sales agent to pay for that monetary loss either by sending a check to the ISO or allowing the ISO to pay the loss with the sales agent’s residuals. Once the loss has been paid then the sales agent residual should continue for the life of the merchants.

Determining under what circumstances an ISO can cancel your residual is of critical importance in negotiating an Agent Agreement. Although most Agent Agreements contain a “material breach” clause, the typical sales agent should work to have that term removed and replaced. Having a specific list of reasons that the sales agent can lose its residual is much more favorable to the agent than the typical broad material breach provision.

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