



A Robinson+Cole Legal Update

Coronavirus (COVID-19)

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Efficient Breach of Contracts in the COVID-19 Era

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The COVID-19 pandemic continues to cause unprecedented disruption for businesses across all regions and industries, with contractual performance significantly challenged in many instances. This has resulted, in some cases, in parties looking for justifications or defenses to break their commitment under their agreements, relying on notions such as material adverse effect, force majeure, frustration of purpose, and impracticability/impossibility. In addition, some parties also are considering the doctrine of “efficient breach” in order to determine how best to evaluate continuing performance under a contract that may now prove unprofitable.

What is the Doctrine of Efficient Breach?

The doctrine of efficient breach recognizes that under certain circumstances it may make more economic sense to breach a contract and pay the expectation damages to the non-breaching party than to perform. As explained by the Delaware Supreme Court in *Leaf Invenenergy Co. v. Invenenergy Renewables LLC* [1], “efficient breach is based on the idea that a party might find it economically worthwhile to breach a contract because that breach yields economic benefits that exceed the value of the damages it must pay to the non-breaching party.”

Two common scenarios relating to the doctrine of efficient breach are: (1) a party decides not to perform a contract because the cost of performing significantly exceeds the damages it is required to pay to the non-breaching party for non-performance (i.e., a breach is committed for the purpose of avoiding a larger loss); and (2) a party decides not to perform a contract because it has received a better offer from a third party that will make the breaching party financially better off even after paying the damages to the non-breaching party.

The doctrine of efficient breach is generally considered by legal practitioners to be a last resort, because it does not modify damages calculations and requires the breaching party to pay expectation damages to compensate the non-breaching party’s loss of expected profit (which is the difference between the contract price and the cost of performance of the non-breaching party). Damage models often can be complicated and subject to varying interpretations. As such, this doctrine should only be considered if the economic benefits of non-performance outweigh the amount of expectation damages.

Fiduciary Duty of Boards of Directors

Boards of directors owe a fiduciary duty of care to their corporations and stockholders. There may be circumstances in which the fiduciary duty of a board of directors requires it to evaluate whether their corporation should breach a particular contract relying on the doctrine of efficient breach, and an efficient breach may be a responsible and sensible decision.

In *Frederick Hsu Living Trust v. ODN Holding Corp.*[2], the Delaware Court of Chancery held that, “the fact that a corporation is bound by its valid contractual obligations does not mean that a board does not owe fiduciary duties when considering how to handle those contractual obligations; it rather means that the directors must evaluate the corporation’s alternatives in a world where the contract is binding. ... Under [the] doctrine [of efficient breach], a party to a contract may decide that its most advantageous course is to breach and pay damages. ... [A] board of directors may choose to breach if the benefits (broadly conceived) exceed the costs (again broadly conceived).”

Conclusion

The COVID-19 pandemic has starkly illuminated that certain contracts might, from a business perspective, be unwise to complete, and as such, management and boards of directors may need to consider breaching such contracts when fulfilling their fiduciary duties. The decision regarding whether to efficiently breach a contract requires a careful analysis and comparison between the cost to perform the contract and the amount of expectation damages for non-performance to fully compensate the non-breaching party. Given some of the complexities inherent in successfully pursuing this doctrine for companies that are contemplating an efficient breach, they would be well served to seek legal and other professional advice to evaluate and discuss the potential consequences that could occur from such a decision.

FOOTNOTES

[1] No. 308, 2018 (Del. May 2, 2019)

[2] Del. Ch. Apr. 14, 2017

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