Revisiting The Benefits Of An Efficient Contract Breach

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With the recent (and continuing) adverse financial impact of the COVID-19 outbreak, many parties may be considering whether to terminate or amend ongoing contractual obligations, and, relatedly, are forced to think through the damages, and possible benefits, that may result from the nonperformance of a contract.

While a number of practitioners have recently commented on certain aspects of contract law that may afford a party the opportunity to not perform (such as force majeure or impracticability), it is beneficial to revisit the theory of an "efficient breach" of a contract and its potential relevance in these uncertain and unparalleled financial times to understand the benefits the theory may (and may not) provide.

The theory of an efficient breach of a contract is based on the premise that a party may find it economically beneficial to intentionally breach its obligations under a contract because the benefits incurred from such breach outweigh the expectation damages that would need to be paid to the nonbreaching party for the breach.

The theory argues an efficient breach favors social policy because allowing the breaching party to pay expectation damages permits (and even encourages) a party to breach a contract when continuing to perform becomes inefficient, thereby increasing social welfare: The breaching party incurs less harm than it would from performing while the nonbreaching party receives expectation damages intended to provide it with the benefit of the bargain it expected from a fully performed contract.

Benefits of an Efficient Breach

Although the efficient breach theory as a primary defense by a breaching party has not been extensively battle-tested in a wide variety of contract disputes, a number of prominent state courts, including Delaware courts in recent decisions, have accepted and thoroughly addressed the concept.

In 2019, the Delaware Supreme Court in Leaf Invenergy Co. v. Invenergy Renewables LLC explained that an "[e]fficient breach is a concept that recognizes that properly calculated expectation damages increases economic efficiency by giving the other party an incentive to break the contract if, but only if, he gains enough from the breach that he can compensate the injured party for his losses and still retain some of the benefits from the breach."[1]

As a result of the financial distress due to COVID-19, a greater number of occasions may present themselves for certain parties to consider whether it would be efficient to not perform a contract by generally fitting into one of the two more common scenarios associated with the efficient breach theory: (1) a seller has contractually agreed to sell a product to a buyer but breaches the contract in order to resell the product to a third party offering a better price, or (2) a party that is contractually obligated to perform but breaches its obligation because the cost of completing performance has become economically untenable and would exceed the value that the other party expects to receive from the

breaching party's performance.

By way of example, the following is an illustrative example of a clear instance in which an efficient breach of a contract may be appropriate:

> A signs a contract to deliver 100,000 custom-ground widgets at $0.10 per widget to B, for use in A's factory. After A has delivered 10,000 to B, C comes to A, explains that he desperately needs 25,000 custom-ground widgets at once since otherwise C will be forced to close its factory at great cost, and offers A $0.15 apiece for 25,000 widgets. A sells C the widgets and as a result does not timely complete delivery to B, who sustains $1,000 in damages from A's breach. Since A obtained an additional profit of $1,250 on the sale to C, A is better off even after reimbursing B for its loss. Society is also better off. Since C was willing to pay A $0.15 per widget, it must mean that each widget was worth at least $0.15 to C. But it was worth only $0.14 to B (i.e., $0.10, what B paid, plus $0.04 ($1,000 divided by 25,000), B's expected profit). Thus, the breach resulted in a transfer of the 25,000 widgets from a lower valued use to a higher valued use.[2]

Further, Delaware courts (among other courts that have also analyzed this theory) have noted that boards of directors (or similar governing bodies) of a party considering whether to knowingly breach an inefficient contract are able to rely on the efficient breach theory while complying with their fiduciary duties if it is decided that a breach is the most appropriate course of action.

Boards of directors (or similar governing bodies) owe fiduciary duties to their equityholders that generally require them to act solely within the scope of their authority, act in good faith, and not allow personal interests to prevail over the company's or equityholders' interests and act with care as a prudent person would under similar circumstances.

A board of directors (or a similar governing body) may be found to have otherwise violated its fiduciary duties if it permits or causes the company to breach a contract resulting in the payment of damages to the nonbreaching party.

However, in Frederick Hsu Living Trust v. ODN Holding Corp., the Delaware Court of Chancery noted 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,"[3] and although a company may be bound by "an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach."[4]

Boards of directors may appropriately make the decision to efficiently breach a contract (and their fiduciary duties may, in fact, obligate a breach of contract) "if the benefits (broadly conceived) exceed the costs (again broadly conceived)."[5]

Efficient Breach Theory Does Not Modify Damages Calculations

Of equal importance, however, for any party that is considering breaching an inefficient contract is to understand what the efficient breach theory does not do.

Again in Leaf Invenergy, the Delaware Supreme Court reversed the Court of Chancery's decision and corrected the lower court's misapplication of the efficient breach theory by

clarifying that an efficient breach (1) does not bar recovery by the nonbreaching party for damages caused by the breach and (2) does not "bypass the usual method of calculating damages."[6]

Instead, when a breach occurs, the correct measure of damages should be to give the nonbreaching party the benefit of the bargain that it expected when it entered into the contract (including any limitations on the recovery of certain types of damages that may be included in the contract), which is the same general standard for the determination of damages in any other breach context.

Obviously, in contracts in which the expectation damages to the nonbreaching party are more easily discernible (i.e., liquidated damages), the breaching party is able to more confidently determine both the efficiency of the breach and the amount of damages the nonbreaching party will be entitled to receive in connection with such breach. However, the Leaf Invenergy court noted that liquidated damages and other similar remedial provisions in contracts are not the only ways for a contract to specify the damages resulting from a breach.

By way of example, the court provided that "in a sales contract in which the seller fully performs and the buyer doesn't pay at all, the seller would be entitled to the sales price in a contract,"[7] and even if the expected economic position (in a contact that is fully performed contract) is not "under a liquidated damages section [in a contract], it nonetheless acts as a contractually specified — and controlling — index for damages, ... [and] the parties need not have stipulated that the [expected economic position of the nonbreaching party] would be recoverable as damages"[8] in order for it to be the correct measure of economic damages in the context of an efficient breach.

Conclusion

Companies are facing an unprecedented level of difficult decisions due to market uncertainty caused by the COVID-19 crisis. Contracts that were otherwise beneficial to a company may no longer yield the economic benefit that the company previously contracted for upon its execution, or companies may find opportunities to direct products or services to other buyers that are willing to pay more than current contracted prices.

The efficient breach theory, when used appropriately and thoughtfully, provides companies (and governing bodies like boards of directors) a justifiable opportunity to mitigate losses incurred from unstable and unprofitable contracts. In the absence of alternatives that may otherwise allow a company to suspend or terminate performance under a contract without paying damages (such as a force majeure situation), a company may decide that it is more advantageous for it to pay damages for a breach of contract instead of performing its obligations under the theory that it is an efficient breach.

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[1] Leaf Invenergy Co. v. Invenergy Renewables LLC, 210 A.3d 688, 703 (Del. 2019),

reargument denied (May 20, 2019) (quoting Bhole, 67 A. 3d at 454 (quoting Dupont v. Pressman, 679 A.2d at 445-46)).

[2] Richard Posner's Economic Analysis of Law

[3] Frederick Hsu Living Tr. v. ODN Holding Corp., No. CV 12108-VCL, 2017 WL 1437308, at *24 (Del. Ch. Apr. 14, 2017), as corrected (Apr. 24, 2017).

[4] Frederick Hsu Living Tr. v. ODN Holding Corp., No. CV 12108-VCL, 2017 WL 1437308, at *24 (Del. Ch. Apr. 14, 2017), as corrected (Apr. 24, 2017).

[5] Frederick Hsu Living Tr. v. ODN Holding Corp., No. CV 12108-VCL, 2017 WL 1437308, at *24 (Del. Ch. Apr. 14, 2017), as corrected (Apr. 24, 2017).

[6] Leaf Invenergy Co. v. Invenergy Renewables LLC, 210 A.3d 688, 703 (Del. 2019), reargument denied (May 20, 2019).

[7] Leaf Invenergy Co. v. Invenergy Renewables LLC, 210 A.3d 688, 702 (Del. 2019), reargument denied (May 20, 2019).

[8] Leaf Invenergy Co. v. Invenergy Renewables LLC, 210 A.3d 688, 702 (Del. 2019), reargument denied (May 20, 2019).