

SPOTLIGHT ON COVID-19



HOULIHAN LOKEY

Efficient Breach

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The disruption caused by the COVID-19 pandemic is likely to have caused many existing business contracts to become economically unviable, absent renegotiation. Continued performance under such contracts can threaten a company's financial well-being. Accordingly, boards of directors should consider the merits of discontinuing performance under such onerous contracts.

Fortunately, the law of contracts recognizes certain concepts, such as *force majeure*, to address unforeseen changes in business conditions. Included among those concepts is that of "efficient breach," which applies when it is economically advantageous for a party to breach a contract because the benefits of the breach outweigh the damages the breaching party will owe. The breaching party is better off than it would be if it had continued performing, while the non-breaching party receives expectation damages that reflect the benefit of the bargain it expected from a fully performed contract.

The Delaware Supreme Court has observed that an "[e]fficient breach is a concept that recognizes that properly calculated expectation damages increase 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." In another Delaware decision, a vice chancellor noted that "[e]ven with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach."

The decision to efficiently breach an onerous contract requires a rigorous analysis of the trade-off between the cost to perform and the expectation damages that will have to be paid to the non-breaching party. With a long history of successfully providing expert testimony in contract disputes and with a best-in-class valuation practice, Houlihan Lokey can provide a board of directors (or a special litigation committee of the board) with the quantitative analytical support and the practical litigation perspective necessary to provide a preliminary basis for evaluating settlement options and for deciding whether an efficient breach of a burdensome contract is in the best interests of the company and its stockholders.

Regardless of whether our assistance is in a consultative capacity or as an expert witness before a trier of fact, supportably deriving expectation damages requires sound technical execution grounded in a blend of research and analytical skills coupled with a familiarity with, and understanding of, the relevant industry and capital market forces, conditions, and

behavior. In particular, analytical tools such as benchmarking, avoided cost frameworks, strategic assessments, probability assessments, and optionality may be used to develop an informed perspective as to what was reasonably knowable, foreseeable, and measurable at the time of breach (i.e., that which was “expected”) from that which is speculative. Application of these techniques enables us to assist our clients and their counsel in contingency and/or best-case and worst-case planning.

For further information regarding efficient breach and Houlihan Lokey's dispute resolution expertise, please visit [HL.com](https://www.hl.com) or contact our team members listed below.

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