



Professional Perspective

Litigating Breach of Contract Matters During Covid-19

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The Covid-19 pandemic has brought significant financial hardship for businesses in the U.S. and around the world. Companies face difficult decisions related to their existing contracts because, in some cases, they owe other parties funds for raw ingredients or supplies and they are unable to earn revenue for the sale of final goods or provide the services that generate income due to the pandemic. They are put in the position of considering whether to re-negotiate their contracts, seek concessions, pursue amendments to contracts, or breach their agreements.

This article approaches the issue of breach of contract damages from a legal perspective, but also from an economist's perspective. The goal of defense counsel in these kinds of cases is to pull the case back to its core, to seek to dismiss the claims that are overreaching and to bring it back to the parties' contract and the associated damages for breach of contract.

In some cases, companies pursue legal claims as a way to escape onerous contract terms. These cases can include traditional breach of contract theories, but also include tort claims, such as tortious interference with current or prospective contractual relationships, conspiracy claims, breach of fiduciary duty, fraud, or other statutory claims, such as RICO claims or those based on antitrust or franchise law.

This type of creative pleading can turn a simple breach of contract action into an otherwise much more complex piece of litigation that puts pressure on the parties to settle the matter. In addition to normal breach of contract damages, these kinds of claims can seek to open the door to creative damages theories, such as those normally associated with tort claims or other statutory damages, including punitive damages, trebling of damages, and attorney's fees.

Legal Strategy

The temptation to spin an otherwise "ordinary" breach of contract claim into tort-related claims is overwhelming when companies are facing financial hardship. The goal in those cases, from a defense perspective, is to strip away the gloss on the claims and focus on the parties' contract and the purported breaches of this contract. This requires an early focus on the facts associated with the claims and the preparation of an aggressive motion to dismiss the tort claims.

For example, considering a Rule 12(b)(6) motion to dismiss for failure to state a claim upon which relief can be granted is useful. As explained by the U.S. Supreme Court in *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007), to "survive a motion to dismiss [under Rule 12(b)(6)], a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'"

A claim is facially plausible only "when the plaintiff pleads factual content that allows the court to draw [a] reasonable inference that the defendant is liable for the misconduct alleged." 556 U.S. at 678 (citing *Twombly*, 550 U.S. at 556). While the court must "assume [the] veracity" of any "well-pleaded factual allegations" in the complaint, conclusory allegations "are not entitled to the assumption of truth." 556 U.S. at 679.

Stripping away these issues narrows the claims and simplifies the damages. However, even assuming the case is focused solely on breach of contract claims, there is still a special need to focus on the nature of the damages claimed. Covid-19 presents unique circumstances for parties to claim damages that are not causally related to the contract breach. There are three types of damages a non-breaching party can claim:

- Expectation or benefit of the bargain damages that put the plaintiff in the position it would have been in had the contract been performed as agreed
- Reliance damages that restore the plaintiff to the position it would have been in had the contract never been made
- Restitution damages that return the funds to the plaintiff that it expended on the contract

Estimating Lost Profits Damages

In many cases involving breach of contract, plaintiffs seek expectation damages in the form of lost profits. For a breach of contract damages claim during the Covid-19 pandemic, special attention is required to isolate the cause of any alleged lost

profits and to determine whether appropriate mitigation activities were undertaken. While causation and mitigation are considerations in any lost profits calculation, these issues take on additional significance in extraordinary economic environments such as the present situation.

It is important to recognize that many of the losses that various businesses have realized may be attributable to unique and unexpected events such as shelter-in-place orders and business restrictions on certain types of establishments. Irrespective of any breach of contract, these events may have adversely affected the plaintiff, and the defendant is not responsible for the associated losses. Moreover, while the plaintiff has a duty to undertake appropriate mitigation of damages due to a breach of contract, defendants may argue that plaintiffs did too little to mitigate losses attributable to other economic factors and that damages should be reduced accordingly.

Fundamentally, the goal of a lost profits analysis is to return the plaintiff to the financial position it would have enjoyed had the breach not occurred. To do so, the general framework is to compare the profits that would have been obtained absent the breach to those that were realized. Although what actually occurred can be analyzed, it is not possible to observe a world where the breach did not occur—what is commonly referred to as the “but-for world.” Rather, this world must be estimated using an economic model.

A first step in estimating lost profits is to estimate the incremental revenues that would have occurred in the but-for world. Estimates of lost revenues are often based on financial statements, budgets, projections, or marketing plans that were prepared by the plaintiff in the normal course of business, as well as the contract itself. However, information from these types of documents may need to be adjusted to account for other relevant factors that may have affected the plaintiff's financial performance irrespective of the alleged breach. Revenues lost due to other factors (i.e., not caused by the breach), such as business restrictions or reductions in demand due to Covid-19 should not be included in a lost revenues calculation since they are not caused by the defendant's alleged actions. In many cases, projections where an underlying assumption was a “normal” economic environment will need to be adjusted downward to account for the current downturn.

After lost revenues are estimated, appropriate costs must be subtracted to obtain lost profits. The goal is to identify the incremental costs that would have been incurred in generating the lost revenues. These additional costs can be estimated using various methods, including applying historic cost ratios, profit margins, or regression analysis, which is a form of statistical analysis. Only the incremental costs associated with the lost revenues should be included. For example, rent associated with a building may not change as revenue increases, but additional labor may be required, for example, to fill additional orders. As with lost revenues, it is important to consider the economic circumstances and make appropriate adjustments to estimates that are based on historic information.

Once estimates of lost revenues and incremental costs are obtained, then lost profits are calculated as lost revenues less incremental costs. However, this estimate of lost profits may need to be adjusted to account for any appropriate mitigation that should have occurred in the actual world. When a breach of contract has occurred, the plaintiff has a duty to mitigate the effects of the breach and reduce damages. For example, the rent associated with a building may not be avoidable, but retaining additional staff that were not needed may have reduced actual profits below the level that was prudent under the circumstances.

In addition, actual profits may have been reduced because of the pandemic, and defendants may argue that additional revenues could have been earned or certain costs could have been avoided. For instance, there may have been actions that plaintiff could have taken to increase revenues, such as selling to different customers or through a different channel. For example, dine-in restaurants have been filling more carry-out orders.

This analysis may not be simple and the appropriate mitigation may be disputed, as issues such as government assistance contingent on maintaining a workforce may complicate the analysis. Nevertheless, to the extent that appropriate mitigation activities were not undertaken in the actual world, damages should be reduced by an amount associated with appropriate mitigation.

Conclusion

Companies facing breach of contract lawsuits and related tort claims that have arisen during the global pandemic have to be diligent in implementing legal strategies that narrow the legal claims and that carefully scrutinize the damages claimed. Looking at causation and mitigation issues behind the legal claims and the damages that flow from them may lead to effective measures to defend them.