REMEDIAL THEORY IN CONTRACT LAW: COMPENSATION; THE THEORY OF EFFICIENT BREACH; COVER; ACTUAL AND VIRTUAL SPECIFIC PERFORMANCE; AND DISGORGEMENT

by

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INTRODUCTION

Remedial theory in contract law presents a number of deep normative puzzles. Among these are the following:

1. *Compensation*. In most areas of law, "compensation" is the amount required to restore the victim of a wrong back to the position that he was in before he interacted with the wrongdoer or, to put it differently, to make good the victim's loss. Under the expectation measure of damages in contract law, however, "compensation" is the amount required to put the victim of a breach of contract forward to the position that he would have been in if the contract had been performed or, to put it differently, to provide the victim with his expected gain. Is the expectation measure really compensatory in the ordinary meaning of that term? If not, is the expectation measure justified?

2. *The theory of efficient breach*. Call a party who has breached a contract the promisor, and call the party who is aggrieved by a breach the promisee. [1] It is generally accepted that a promisor is under both a moral and a legal obligation to perform a bargain promise. However, the theory of efficient breach—which is widely accepted in law and economics, and has obtained a toehold in mainstream legal sources—takes the position that breach is acceptable, and indeed

[1] For ease of exposition, throughout this Article I will use the feminine pronoun to refer to a promisor or a seller, and the masculine pronoun to refer to a promisee or a buyer.

should be encouraged by contract law, where the promisor's gains from breach exceed the promisee's losses. Is that theory valid?

3. *Cover*. Where a seller fails to deliver a commodity that she has contracted to supply, a traditional measure of damages is the market-price measure—the difference between the contract price of the commodity and the market price of the commodity at the time of breach. An alternative to the market-price measure is the cover measure—the difference between the contract price and the price of a substitute that the buyer purchases on the market. The cover measure has important advantages over the market-price measure, but it raises the following question: When the substitute differs from the contracted-for commodity, what principle should determine whether the purchase constitutes cover? In particular, should that principle depend on whether, in making the substitute purchase, the buyer acted reasonably, or on whether he acted in good faith?

4. *Specific performance*. Traditionally, specific performance has been considered an exceptional remedy. However, it can readily be shown that expectation damages, although aimed at providing the promisee with his expected gain, in fact systematically fall short of that objective. Moreover, the promisor has promised to perform, not merely to pay damages. Since breach of contract is a wrong, why should not the promisor be compelled to do what she promised to do? These problems raise the issue whether specific performance should be routinely available, rather than exceptional. And if specific performance should not be routinely available, what principle should govern its availability?

5. *Disgorgement*. Suppose a promisor's gains from breach exceed the promisee's losses from breach. Should the promisor then be made to disgorge those gains? Compensation focuses on the promisee's loss from breach, as "loss" may be defined. Under the theory of efficient

breach, that is just where the focus should be, and traditionally it has been assumed that disgorgement was not available in contract law. However, requiring the promisor to disgorge her gains from breach in appropriate cases protects and supports bargains, expectation damages, and specific performance. Should disgorgement therefore be an available remedy in contract law?

These five deep puzzles are usually treated as separate issues. In this Article, however, I will show that in fact they are intimately connected: The concept of compensation is central to both the theory of efficient breach and to the principles that should govern cover, specific performance, and disgorgement. The theory of efficient breach is at bottom an attempt to justify severe limits on specific performance and disgorgement. The issue, what principle should govern whether a substitute purchase constitutes cover, is intimately tied to the concept of compensation on the one hand, and specific performance on the other. Cover and specific performance, which seem to be independent remedies, are actually bound in a reciprocal relationship. Finally, disgorgement, which appears to be inconsistent with the idea of compensation, is in fact intimately tied to that idea.

I. COMPENSATION IN CONTRACT LAW

The normal remedy for breach of contract is damages. It is not self-evident, however, what conception should guide the way in which contract damages are measured. It is a general principle of law that a party who is aggrieved by a legal wrong is entitled to compensation for his loss. In nonpromissory contexts, like torts, an aggrieved party's loss is normally measured by comparing his injured state with his uninjured state. In a promissory context, however, the ideas of injury and loss, and therefore of compensation, are fundamentally ambiguous, because they

can be instantiated through either of two very different conceptions: a *cost* conception and an *indifference* conception.

Under the *cost conception*, the uninjured state is the condition that the promisee would have been in if he had not made the contract, and loss is the extent to which the promisee is worse off as a result of the promise and breach than he would have been if the promise had not been made. Compensation is then the amount required to restore the promisee to the position that he was in before the promise was made, and is measured by the costs that the promisee incurred as a result of the promise—the reliance measure.

The *indifference conception* is well expressed by Richard Craswell. "The stated goal of contract damages," Craswell says, is "to put the plaintiff in as good a position as he would have been in had the defendant kept his contract. In economic analysis, this is usually translated as . . . the amount necessary to leave the plaintiff absolutely indifferent, in subjective terms, between having the defendant breach and pay damages or having the defendant perform."[2] Under this conception, the uninjured state is the condition that the promisee would have been in if the contract had been performed, and loss is the extent to which the promisee is worse off than he would have been if the promise had been kept. Compensation is then the amount required to make the promisee indifferent between performance and damages, and is measured by the amount required to put the promisee where he expected to be if the contract had been performed—the expectation measure.

There are two reasons why a cost conception might be favored over an indifference conception.

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[2] Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 SO. CAL. L. REV. 629, 636 (1988).

First, the view could be taken that the State should be concerned only with making an aggrieved party whole by restoring him to the position that he was in before he interacted with the wrongdoer, not with making him better off than he was before the interaction.

Second, the injury on which the cost conception is based is more substantial than the injury on which the indifference conception is based. Reliance damages, which give effect to the cost conception, compensate for a loss of what the promisee previously had, as opposed to a failure to obtain a gain that he expected. Economically, the two kinds of loss may seem identical. Psychologically, they are not. Actors are loss-averse; that is, a loss of existing endowments is perceived by actors as a greater harm than a failure to augment their endowments by an equal amount. Accordingly, perceived losses, such as out-of-pocket costs, are more painful than forgone gains, such as potential profits.[3] As Daniel Kahnemann explains it, "There is an asymmetry between gains and losses, and it really is very dramatic and easy to see . . . People discriminate sharply between gaining and losing and they don't like losing."[4]

In short, there are good reasons for favoring the cost conception. But the reasons for favoring the indifference conception are even better. To begin with, in a bargain context strong

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[3] *See, e.g.*, Richard H. Thaler, THE WINNER'S CURSE 63-78 (1992); Amos Tversky & Daniel Kahneman, RATIONAL CHOICE AND THE FRAMING OF DECISIONS, IN THE LIMITS OF RATIONALITY 60 (Karen S. Cook & Margaret Levi, eds. 1990); Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990).

Loss-aversion, the endowment effect (on which loss-aversion is partly based), and some of the evidence for loss-aversion, are nicely summarized in Jeffery Evans Stake, *The Uneasy Case for Adverse Possession*, 89 GEO. L. REV. 2419, 2459-62 (2001):

> The endowment effect is a pattern of behavior in which people demand more to give up an object than they would offer to acquire it. This difference between the amount a person is willing to pay . . . and the amount she is willing to accept . . . has been explained by reference to the theory of loss aversion. According to the theory of loss aversion, losses have greater subjective impact than objectively commensurate gains. In graphical terms, utility curves are asymmetrical in that the disutility of giving up an object is greater than the utility of acquiring it. . . .
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> . . . In one experiment, subjects were given either a lottery ticket or $2.00 cash. When they were given the chance to trade their initial endowment for the other endowment, somewhat surprisingly, very few subjects chose to switch. Almost everyone preferred what they were initially given. . . .

[4] Erica Goode, A *Conversation with Daniel Kahneman; On Profit, Loss and the Mysteries of the Mind*, NEW YORK TIMES, November 5, 2002, Section F, F1, at F6.

reasons of policy—specifically, strong reasons of efficiency—support the indifference conception over the cost conception. It is always possible that events will induce a promisor to breach because performance has become unprofitable or because an alternative performance has become more profitable. Damage measures provide incentives or disincentives for the amount of precaution that a promisor takes to ensure that she will be able to perform, and for his decision whether to perform—that is, for the rate of precaution and the rate of breach. If a promisor was liable only for the promisee's costs, the value of the contract to the promisee would not enter into a purely self-interested calculation by the promisor concerning how much precaution to take and whether to perform or breach. In contrast, at least in principle a regime of expectation damages places on the promisor the value of the contract to the promisee, and thereby efficiently sweeps that value into the promisor's calculus of self-interest when she is making decisions on precaution and breach. Correspondingly, the promisee can plan more effectively under the expectation measure, because once a contract is made, at least in principle he can order his affairs with the confidence that he will realize the value of the contract, either by performance or by damages. In contrast, under a regime of reliance damages a promisee could plan only on the basis that if breach occurs, the law will put him back to where he was when he started. Since planning is by nature forward-looking, the backward-looking nature of reliance damages would be a shaky foundation for ordering complex affairs.[5]

From this perspective, describing expectation damages as compensatory is at best a term of art, and at worse a misnomer. Insofar as the expectation measure is employed because it

[5] It has been argued that the prospect of expectation damages will lead contracting parties to overrely, that is, to invest more heavily in reliance than efficiency requires. However, when institutional considerations are taken into account, in most cases overreliance normally cannot occur, and even in cases in which overreliance can occur, the expectation measure does not in fact fully insure the promisee's reliance. *See* Aaron S. Edlin and Stefan J. Reichelstein, *Holdups, Standard Breach Remedies, and Optimal Investment*, 86 AMERICAN ECONOMIC REVIEW 478 (1996); Aaron S. Edlin, *Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages*, 12 JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION 98 (1996); Melvin A. Eisenberg & Brett McDonnell, *Expectation Damages and The Theory of Overreliance*, 54 HASTINGS L. J. 1335 (2003).

promotes efficiency, the measure is desirable not because it compensates the promisee for his loss, but because it serves a social-welfare purpose. Expectation damages can, however, be justified as compensatory from a moral perspective.

For one thing, in a society in which contracts are enforced, contracts may come to be perceived as tokens of the profits they will generate. In that case, promisees may believe that they have become endowed with those profits, and may perceive a breach as a loss of that endowment.

Moreover, in a bargain context there is a strong reason of fairness for expectation damages. If A has rendered a bargained-for performance to B, we know that A was willing to render that performance to B for the agreed-upon price. We cannot know whether A would have rendered that performance to B for any lesser price. Requiring A to accept any lesser price therefore would unfairly convert him from a voluntary to an involuntary actor, because had he known in advance that the price would be reduced, he might not have contracted and performed. Even where A has not yet performed, fairness may require that compensation be measured by A's expectation because of the likelihood that A has passed up the chance to find alternative opportunities that may no longer be available, and whose value cannot be easily quantified just because as a result of the promise the alternatives were never searched out.

II. THE THEORY OF EFFICIENT BREACH AND THE THEORY OF EFFICIENT TERMINATION

The theory of efficient breach is constructed on the foundation of the expectation measure of damages. In very general terms, the theory holds that breach of contract is efficient and therefore desirable if the promisor's gain from breach (after payment of expectation

damages) will exceed the promisee's loss from breach. This theory is widely endorsed in law and economics, and has gained a toehold—although not much more than that—in mainstream legal sources.[6]

In general, the theory remains much more influential normatively than positively, but if the theory is correct it would provide a rationale for placing narrow limits on the remedies of specific performance and disgorgement, because specific performance prohibits breach and disgorgement strips the promisor of her gains from breach. Accordingly, there are two reasons for examining the validity of the theory. The first reason is to determine whether the central role given to the theory in law-and-economics contracts scholarship is justified. The second reason is that even if the theory cannot be supported in all of its applications, an examination of the cases in which the theory can and cannot be supported will illuminate the classes of cases in which specific performance and disgorgement are or are not appropriate.

Because of the central role given to the theory of efficient breach in law-and-economics, and because an examination of that theory illuminates the principles that should govern specific performance and disgorgement, I will focus on that theory in this Part. However, it is important to put the theory in context by considering a related but more general theory—the theory of efficient termination. That theory simply holds that it is often more efficient to terminate a contract than to perform it. As stated by Paul Mahoney, "Efficient termination is possible when the amount of money, *Y*, that [the promisor] would pay to escape performance at a particular point in time is greater than the amount of money, *Z*, that the promisee . . . would accept in lieu

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[6] *See* Craig S. Warkol, *Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach*, 20 CARDOZO L. REV. 321 (1998). The theory is approved in the Reporter's Note to the Introduction to Chapter 16 of the RESTATEMENT (SECOND) OF CONTRACTS (1981), but Reporter's Notes reflect only the position of the Reporter, not that of the ALI. The theory has also been referred to in several cases as a reason for not granting punitive damages. *See* note xxx, *infra*.

of performance. In that situation there is a potential gain of Y - Z from terminating the contract."[7]

The difference between the two theories is as follows. At the risk of oversimplification, essentially there are two ways to terminate a contract—mutually, by rescission, or unilaterally, by breach. The theory of efficient breach contemplates only unilateral termination, by breach. In contrast, the theory of efficient termination contemplates termination by mutual consent in many or most cases, because usually it is only through mutual consent that the amount the promisee would accept in lieu of performance can be established. As Sidney DeLong has put it, "the promisee's consent to a reallocation of performance resources is the only certain proof of the efficiency" of termination."[8]

A. Prologue

This Prologue consists of three sections. I begin by presenting a preliminary exposition of the theory of efficient breach. I then describe the three major paradigm cases to which the theory might be applied. Finally, I develop the criteria by which the validity of the theory should be determined. Following this Prologue, I examine the theory in light of these criteria in the context of each paradigm.

1. *A Preliminary Exposition of the Theory*. Probably the best-known exposition of the theory of efficient breach is that given by Richard Posner in his book, *Economic Analysis of*

[7] Paul G. Mahoney, *Contract Remedies and Option Pricing*, 24 J. LEG. STUD. 139, 141 (1995).
[8] Sidney W. DeLong, *The Efficiency of Disgorgement as a Remedy for Breach of Contract*, 22 IND. L. REV. 737, 754 (1989).

Law.[9] This exposition has changed somewhat over the six editions of that book. Here is the core of the exposition in the first edition:

> . . . [I]n some cases a party [to a contract] would be tempted to breach the contract simply because his profit from breach would exceed his expected profit from completion of the contract. If his profit from breach would also exceed the expected profit to the other party from completion of the contract, and if damages are limited to loss of expected profit, there will be an incentive to commit a breach. There should be.

It is useful to examine this passage in detail. Posner begins by pointing out that there is a temptation to breach a contract if it is more profitable to breach than to perform. Since all temptations concern a choice between various courses of action, one of which would yield more profit or satisfaction than others, there must be more to the theory than that.

Next, Posner states that if the promisor's profit from breach would exceed the expected profit to the promisee from performance, and if damages are limited to loss of expected profit, there will be an incentive to commit a breach. On the surface, there is not much news here either. Of course there will be an incentive to breach if the promisor gains more from breach than he must pay in damages. But so what? There is also an incentive to steal if the gains from theft are larger than the expected penalty. The existence of an incentive to take an action tells us nothing about whether the action should be encouraged by law.

So something else is required if efficient breach is to be a theory rather than a series of tautological observations. For example, the theory could have been presented as a general principle of positive law derived by induction from more specific doctrines, such as the doctrine

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[9] *See* RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 120 (1st ed. 1972). This book is now in its sixth edition. The discussion of efficient breach has changed in certain respects since the first edition. Most of the changes are discussed in the text below.

Although I focus on Posner's exposition, the theory of efficient breach was first articulated by Robert Birmingham in his article, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970) ("Repudiation of obligations should be encouraged where the promisor is able to profit from his default after placing his promisee in as good a position as he would have occupied had performance been rendered"), and was christened by Charles Goetz and Robert Scott in *Liquidated Damages, Penalties, and the Just Compensation Principle: A Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977).

that specific performance is normally not granted in contract law.[10] So presented, the theory would have little or no normative significance, and therefore would not be a guide to either private or public action.

In fact, however, the theory of efficient breach is not presented in purely descriptive terms. It is also presented in normative terms. "If the [promisor's] profit from breach would exceed the expected profit to the [promisee] from completion of the contract," Posner says, "and if damages are limited to loss of expected profit, there will be an incentive to commit breach. *There should be*."

In terms of clarity, this is not Posner at his best. In more generalized form, taken on their face these two sentences say that if Course of Action A (breach) is more profitable than Course of Action B (performance), there is an incentive to take Course of Action A, and there should be such an incentive. But why should the law provide an incentive for behavior that is already fully incentivized? And what would it mean for the law to provide an incentive for breach?

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[10] The theory might also be induced from the general rule that punitive damages are not awarded in contract law, and indeed the theory is referred to in some cases that apply that rule. *See, e.g.*, Thyssen, Inc. v. SS Fortune Star, 777 F.2d 57, 63 (2d Cir. 1985); Harris v. Atlantic Richfield Co., 14 Cal. App. 4th 70, 17 Cal. Rptr. 2d 649, 653 (Cal. App. Ct. 1993); Kutzin v. Pirnie, 124 N.J. 500, 591 A.2d 932, 941 (N.J. 1991). However, that rule rests on a different ground: wrongly causing a financial injury by breaking a promise, while improper, is not so improper as wrongly causing a personal injury. That the limited use of punitive damages in contract law rests on moral grounds is evidenced by the many cases that hold—inconsistently with the theory of efficient beach—that punitive damages will be awarded for breach of contract if the breach is morally egregious. For example, in Suffolk Sports Center, Inc. v. Belli Construction Corp., 212 A.D.2d 241, 628 N.Y.S.2d 952 (1995), a landlord had barricaded the entrances to the tenant's leased sports facilities during a dispute concerning the lease. In approving punitive damages against the landlord, the court said that punitive damages were available where the breach evinces a " 'high degree of moral turpitude' or is 'actuated by evil and reprehensible motives,' and demonstrates 'such wanton dishonesty as to imply a criminal indifference to civil obligations.' " In Miller v. Byrne, 916 P.2d 566 (Colo.App. 1995), the court said that "Punitive damages are available . . . when a plaintiff is able to prove beyond a reasonable doubt that the defendant engage in 'willful and wanton' misconduct. Willful and wanton conduct means conduct purposefully committed which the actor must have realized is dangerous, done heedlessly and recklessly, without regard to consequences, or of the right and safety of others, particularly of the plaintiff."

Furthermore, in practice punitive damages for breach of contract are not that uncommon. Marc Galanter analyzes data concerning contract litigation in his paper, *Contract in Court; or Almost Everything You May or May Not Want to Know About Contract Litigation*, 2001 WIS. L. REV. 577 (2001). Among Galanter's sources is a study, by the Bureau of Justice Statistics, of contract litigation in 1992 in the seventy-five largest counties in the United States, which account for about one-third of the population. That study, Galanter reports, found that 10.9% of all winning plaintiffs in jury-tried contracts cases were awarded punitive damages. Even in judge-tried contracts cases, winning contracts plaintiffs were awarded punitive damages 3.6% of the time. *Id*. at 606.

The reason for this expository problem is that Posner has packed his real conclusion into an "if" clause. He states that "*if* damages are limited to loss of expected profit" there should be an incentive to commit breach when the promisor's gain from breach will exceed the promisee's loss of his expected profit. Clearly, however, Posner's conclusion is that when the promisor's gain from breach will exceed the promisee's loss, the remedy for breach of contract *should be* limited to loss of the promisee's expected profit. At least in the first edition, Posner's rationale for the "should be" was that breach is an instrument for transferring commodities to higher-valued uses. (I will discuss this point in more detail below.)

The theory of efficient breach is stated in very general terms, but the bite of the theory is narrower than this generality might suggest. Essentially, the theory is a normative argument against the use of contract-law remedies that provide a greater incentive for performance than the incentive provided by expectation damages. For most practical purposes, therefore, the theory boils down to an argument against specific performance and disgorgement. (The theory might also be viewed as a normative argument against punitive damages, but the use of punitive damages in contract law raises issues that go beyond the scope of the theory.[11]) For ease of exposition, I will therefore call Posner's preferred legal regime, which encourages breach under defined circumstances, an *efficient-breach regime,* and I will call its alternative, which encourages performance under many of these same circumstances, by more liberally awarding specific performance or disgorgement, a *performance-oriented regime.*

2. *Three paradigms.* Although the theory of efficient breach is typically presented in very generalized terms, in fact the theory can only be properly understood and evaluated in the context of paradigm cases to which it might meaningfully be applied. Three paradigm cases are salient: the Resale Paradigm, the Loss Paradigm, and the Mitigation Paradigm. Broadly

[11] *See* note xxx, *infra*.

speaking, in the Resale Paradigm a seller who has contracted to sell a commodity to a buyer breaches the contract in order to resell the commodity to a third party who comes along later and offers a higher price. (I use the term *sell* to include provide, lease, and license. I use the term *a commodity* to mean anything that can be sold, including goods, services, real estate, intellectual property, and productive capacity. I use the term *the commodity* to mean a commodity that is the subject of a given contract. I use the term *resale* to mean a sale of a commodity that the seller has already contractually sold.) In the Loss Paradigm, a seller who has contracted to sell a commodity to a buyer breaches the contract because she determines that her cost of production will exceed the value that the buyer places on the commodity. In the Mitigation Paradigm, a buyer who has contracted to purchase a commodity that will take time to produce breaches the contract because before the seller has completed production of the commodity, the buyer determines that the value of the commodity to him will be less than the contract price.

3. *Evaluative Criteria*. There are several criteria under which the theory of efficient breach should be evaluated in the context of each Paradigm.

One criterion for evaluating the theory concerns the information that is likely to be available to a promisor, at the time of the perform-or-breach decision, concerning the loss that the promisee will incur. The theory of efficient breach assumes that promisors will know the promisee's loss from breach. If a promisor does not know the promisee's loss from breach, she will not know whether her gain from breach will exceed the promisee's loss. In the context of the higher-valued use justification of the Resale Paradigm, the theory also assumes that promisors will know, at the time they make a perform-or-breach decision, the relative value of the commodity to the buyer and the third party. If a promisor doesn't know that, she cannot know whether breach will move the commodity to a higher-valued use.

A second criterion for evaluating the theory of efficient breach is the extent to which expectation damages actually are compensatory in the context of each Paradigm. The theory assumes that expectation damages fully compensate a promisee by making him just as well off as would performance. Therefore, if expectation damages are systematically undercompensatory, the theory will not hold. Indeed, in the context of the Resale Paradigm, if expectation damages are systematically undercompensatory on the low side, a seller may resell the to a third party even when she knows that the third party does not have a higher-valued use for the commodity than the buyer, because she will also know that she will not be required to compensate the buyer for the buyer's value.

A third major criterion for evaluating the theory of efficient breach is whether, in the context of each Paradigm, encouraging breach would in fact promote efficiency, even assuming that the promisor has full information and the promisee receives full compensation.

I now apply these criteria to each of the three Paradigms.

B. The Resale Paradigm

1. *Introduction*. The elements of the Resale Paradigm are as follows. (1) A seller has contracted to sell a commodity to a buyer. (2) Thereafter, a third party comes along and offers the seller a better price for the commodity. (3) The gain to the seller from breaching his contract and selling the commodity to the third party will exceed the loss that the buyer will incur from the breach. (4) The seller breaches her contract with the buyer and instead sells the commodity to the third party. (5) The seller pays the buyer damages in an amount that makes the buyer just as well off with breach as he would have been with performance. (6) The commodity is thereby efficiently moved to a higher-valued use.

This Paradigm is the poster child of the theory of efficient breach. Proponents of the theory, including Posner, typically include an illustration that exemplifies this Paradigm as part of their argument for the theory. Here is the centerpiece illustration of the theory of efficient breach in the first edition of Posner's *Economic Analysis of Law*:

> . . . I sign a contract to deliver 100,000 custom-ground widgets at $.10 apiece to A, for use in his boiler factory. After I have delivered 10,000, B comes to me, explains that he desperately needs 25,000 custom-ground widgets at once since otherwise he will be forced to close his pianola factory at great cost, and offers me $.15 apiece for 25,000 widgets. I sell him the widgets and as a result do not complete timely delivery to A, who sustains $1000 in damages from my breach. Having obtained an additional profit of $1250 on the sale to B, I am better off even after reimbursing A for his loss. Society is also better off. Since B was willing to pay me $.15 per widget, it must mean that each widget was worth at least $.15 to him. But it was worth only $.14 to A—$.10, what he paid, plus $.04 ($1000 divided by 25,000), his expected profit. Thus the breach resulted in a transfer of the 26,000 widgets from a lower valued to a higher valued use.[12]

As this illustration makes clear, in the context of the Resale Paradigm the validity of the theory of efficient breach rests on two factual predicates and an efficiency justification.

The two factual predicates are as follows. First, at the time of a perform-or-breach decision, a seller normally knows what loss a buyer will incur from breach and also knows that the third party has a higher-valued use for the commodity than the buyer. I call this *the information predicate.* Second, expectation damages make buyers indifferent between performance, on the one hand, and breach and compensation, on the other. I call this *the compensation predicate*.

The standard efficiency justification is that given by Posner in his illustration: Permitting the seller to resell and keep the extra profit is an instrument for transferring commodities to higher-valued uses.

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[12] POSNER, *supra* note xxx, at 121.

In considering these two factual predicates and the efficiency justification, it needs to be understood that in the context of the Resale Paradigm, the theory of efficient breach has no bearing on contracts for the sale of homogeneous (that is, fungible or undifferentiated) commodities.[13] This is because where a commodity is homogeneous, the price that a third party will pay the seller is also the measure of the buyer's damages. For example, suppose that on January 2, Seller agrees to sell to Buyer 1000 bushels of US No. 2 Hard Red Wheat ("No. 2 wheat") for $4.00/bushel, delivery on March 1. On February 15, Seller sets aside 1000 bushels and identifies them to Buyer's contract. On March 1, the market price of No. 2 wheat for immediate delivery is $4.50/bushel. That day, Third Party offers to buy 1000 bushels of No. 2 wheat from Seller. Seller sells to Third Party the 1000 bushels she had identified to the contract with Buyer. Third Party will pay $4.50/bushel for the wheat, no more and no less. However, Buyer will be entitled to damages equal to the difference between the market price ($4.50/bushel) and the contract price ($4.00/bushel). As a result, Seller's gain from breach ($500) will be equal to Buyer's loss and damages (also $500). Accordingly, at least in principle Seller will have no incentive to breach—and indeed under the theory of efficient breach she should not breach, because her gain will not exceed Buyer's loss.[14] Of course, experience suggests that sellers of homogenous commodities sometimes do breach. Such breaches, however, are not motivated by efficiency and are not explained by the theory of efficient breach.

[13] The theory could have a bearing where a homogeneous commodity is in critically short supply, but such cases are not often found, and for ease of exposition I will not consider these cases separately in the text of this Part. For a discussion of such cases, see Part IV, *infra*.

[14] There is also an issue of causation, stressed by Farnsworth in the context of the related problem of disgorgement, which I address in Part V. *See* Alan Farnsworth, *Your Loss or My Gain?*, 94 YALE L.J. 1339, 1341, 1343-44 (1983). The argument is that Seller's *resale* may be deemed not to be the cause of her breach, because notwithstanding the resale, Seller could have delivered 1000 bushels of No. 2 wheat to Buyer, either by delivering wheat out of inventory, if she had it, or by purchasing wheat on the market for delivery to Buyer, if she didn't.

Instead, they are typically motivated by imperfections in compensatory damages—imperfections that, as the seller knows, dampen a buyer's incentives to bring suit.[15]

Given that the theory of efficient breach has no bearing on the resale of homogeneous commodities, I turn to the validity of the theory in the resale of differentiated commodities.

2. *The information predicate.* In the context of the Resale Paradigm, the seller is the sole decisionmaker—that is, the decision to perform or breach lies exclusively in the seller's hands. Since breach is justified under the theory of efficient breach only if the seller's gain from breach will exceed the buyer's loss, it is a factual predicate of the theory that when making a perform-or-breach decision, a seller knows whether her gain will in fact exceed the buyer's loss. In the case of contracts for the sale of differentiated commodities, however, a seller will seldom know what profits the buyer will lose as a result of the seller's breach. At best, the seller will know the general nature of the use to which the buyer intended to put the commodity at the time the contract was made. Seldom if ever will a buyer quantify for the seller the profits he intends to make from that use, because the price of a differentiated commodity is usually bargained-out within a range, and knowledge of the profits that the buyer will generate from the commodity would give the seller a bargaining chip to increase her price. Furthermore, after the contract is made the buyer may create or discover a more valuable use for the commodity than the use he had when the contract is made.

To put this differently, the seller normally will not know what value the buyer places on the commodity at the time of the perform-or-breach decision. Even at the time the contract was made, the value of the commodity to the buyer must have exceeded the contract price, or he would have not have made the contract. If the buyer is purchasing the commodity as an input or factor of production, the value of the commodity to the buyer will almost certainly have

[15] *See* text at notes xxx-xxx, *infra*.

increased after the contract was made, because buyers who make forward contracts for the delivery of differentiated commodities will normally engage in various forms of beneficial reliance that will lose value if the commodity is not delivered.

Correspondingly, the seller normally will not know, at the time of the perform-or-breach decision, whether the third party *values* the commodity more highly than the buyer. Instead, the seller will know only that the seller is willing to *pay* more than the buyer agreed to pay at an earlier time.

In short, in the context of the Resale Paradigm, the information predicate is incorrect. This reality is masked by the form of the illustrations that proponents of the theory use. In real life, a perform-or-breach decision must be made by a seller who will have highly imperfect information about the buyer's value and the third-party's value. In contrast, proponents of the theory support it with illustrations that feature an omniscient narrator who looks down from academic Heaven, has perfect information, and knows everyone's subjective value. So, for example, the narrator of Posner's custom-ground-widgets illustration—that is, Posner—knows to the penny exactly how much profit the buyer would make if the seller performed rather than breached.

The seller's impoverished information concerning the buyer's value, under the theory of efficient breach, stands in sharp contrast to the information available under the theory of efficient termination. Under that theory, a contract that is inefficient to perform, in the sense that the amount the seller would pay to escape performance exceeds the amount the buyer would accept to release the seller, can be terminated by mutual consent. If a contract is terminated by mutual consent, the seller is not the sole decisionmaker, and the buyer, whose consent is required, has perfect information concerning his own valuation. Accordingly, a decision to terminate under

the theory of efficient termination will be based on much more reliable information than a decision to breach under the theory of efficient breach.

Posner himself, wearing his judicial hat, came pretty close to this position in *Walgreen Co. v. Sara Creek Property Co.*[16] Walgreen operated a pharmacy in a Mall owned by Sara Creek. Under Walgreen's lease, Sara Creek promised not to rent space in the Mall to any other person who wanted to operate a pharmacy or a store containing a pharmacy. Well into the term of the lease, Sara Creek informed Walgreen that it intended to buy out the anchor tenant in the Mall and install a Phar-Mor discount store in its place. This store would include a pharmacy the same size as Walgreen's and would be within 200 feet of Walgreen's store. Moreover, Phar-Mor probably would sell pharmaceuticals at lower prices than Walgreen. Walgreen sought an injunction against the new lease. (Injunctive relief is often equivalent to specific performance, particularly where, as in *Walgreen*, the promise is to not do a certain act.[17]) Posner upheld an injunction against Sara Creek on the ground that if an injunction was issued, the parties could negotiate for Walgreen's surrender of its right to enforce the decree in exchange for compensation, and the negotiating process was a much better way to determine Walgreen's loss than the adjudicative process:

> The benefits for substituting an injunction for damages are twofold. First, it shifts the burden of determining the cost of the defendant's conduct from the court to the parties. If it is true that Walgreen's damages are smaller than the gain to Sara Creek from allowing a second pharmacy into the shopping mall, then there must be a price for dissolving the injunction that will make both parties better off. . . . [A] premise of our free-market system, and the lesson of experience here and abroad as well, is that prices and costs are more accurately determined by the market than the government. A battle of experts is a less reliable method of determining the actual cost to Walgreen of facing new competition than negotiations between Walgreen and Sara Creek over the price at which Walgreen would feel adequately compensated for having to face that competition.[18]

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[16] 966 F.2d 274 (7th Cir. 1991).
[17] *See* Dobbs, *supra* note xx, at 190. Indeed, specific performance can be viewed as a form of injunctive decree. *Id.*
[18] *Walgreen* at 278.

3. *The compensation predicate.* A second factual predicate of the theory of efficient breach, in the context of the Resale Paradigm, is that if the seller breaches the buyer will be fully compensated in an amount that makes him just as well off with breach as he would have been with performance. As Posner put it in the first edition of *Economic Analysis of Law*:

> . . . [I]f the profit that [the breaching party] would make from a breach . . . is greater than his profit from completion, then completion will involve a loss to him. If that loss is greater than the gain to the other party from completion, it is clear that commission of the breach would be value maximizing and should be encouraged. And because the victim of the breach is made whole for his loss, he is *indifferent* [between breach and performance]. . . .[19]

This predicate is also incorrect. As Posner makes clear, the compensation predicate of the theory of efficient breach is identical to the indifference conception of compensation. The standard legal remedy for breach of contract is damages calculated under the expectation measure. Because the expectation measure is rooted in the indifference conception, it would be easy to conclude that the expectation measure in fact compensates the promisee in a way that will make her indifferent between performance and breach. It doesn't. On the contrary, in cases involving the sale of differentiated commodities, the expectation measure falls far short of giving full effect to the indifference conception, as a result of a cluster of legal rules. The most significant rules in this cluster concern the cost of obtaining compensation, the manner in which market-price damages are calculated, the operation of the requirement of certainty, the principle of *Hadley v. Baxendale*, and the calculation of pre-judgment interest.

In the first instance, a buyer's damages are normally measured by the difference between the contract price of the commodity and either its market price when the buyer learns of the breach or by the cost of cover—that is, the cost of a substitute purchase. In lieu of or in addition to these first-instance damages, a buyer may be allowed to recover the profits he lost as a result

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[19] POSNER, *supra* note xxx, at 120. (emphasis added.)

of the breach. Cover is subject to three important limitations. In some cases, cover cannot be achieved; in some cases, cover can be but is not achieved; and in some cases the buyer's determination of what constitutes cover is not respected by the courts. I will discuss cover damages in Part III. In the balance of this section, I will discuss market-price damages and damages for lost profits. I will show that both kinds of damages are systematically undercompensatory.

(a) *The costs of obtaining compensation*. To begin with, true compensatory damages, defined as "the amount necessary to leave a promisee absolutely indifferent, in subjective terms, between having the defendant breach and pay damages or having the defendant perform,"[20] would include the costs of obtaining compensation, because the promisee would not incur those costs if the promisor had performed. In fact, however, the costs of obtaining compensation are not included in expectation damages based either on market price or lost profits. Proponents of the theory of efficient breach implicitly assume that a breaching promisor will make compensation graciously and costlessly. Of course, that almost never occurs. Instead, the promisee normally will need to incur substantial costs to obtain compensation, and these costs are normally not compensable by expectation damages. Specifically, expectation damages do not compensate for the value of the promisee's time in determining his losses, the promisee's costs to retain experts to aid in that determination, the value of the promisee's time in negotiating to recover his losses, or—under the American rule that governs the cost of litigation generally—legal fees and other costs of litigation.

(b) *The manner in which market-price damages are calculated*. I turn now to damages based on the difference between the contract price and the market price at the time of breach. In a contract for the sale of a homogeneous commodity, "market price" means just that; an

[20] Craswell, *supra* note xxx, at 636.

observable price on an observable market. In such cases, there is no reason to be concerned with the promisee's subjective valuation of the commodity, because by hypothesis every unit of the commodity is identical. Accordingly, putting aside the costs of obtaining compensation, the promisee's subjective valuation will be satisfied if, following breach, he replaces himself by a purchase on the market and then recovers from the promisor the difference between the market price and the contract price.

However, in contracts for the sale of differentiated commodities—the only commodities to which the theory of efficient breach is relevant—market price typically is not a real entity. Rather, it is a construct—an extrapolation from prices charged in transactions involving different although roughly comparable commodities, occurring in different although roughly comparable places, and at different although roughly comparable times.

To some extent, whether market-price damages are actually compensatory in cases involving differentiated commodities will depend on random error. If, because the extrapolation from other transactions is erroneous, the market-price construct is too low, the buyer will be undercompensated; if too high, he will be overcompensated. In one major class of cases, however, buyers will be systematically undercompensated. These are cases in which even though the extrapolation is not erroneous, the market-price construct, which is objective and based on the valuations of other parties, for their own purposes, is less than the value that the buyer places on the commodity. If the buyer's valuation of the commodity exceeds this market-price construct, damages will not be compensatory, because the buyer will not be indifferent between damages and performance.

For example, suppose that a buyer has contracted to purchase a used 1998 Schwabe SR81 150-ton die press for $59,000, which he intends to use in his production process. The die press is

to be delivered at the buyer's place of business in Las Vegas on March 1. On that date, the seller defaults and sells the die press to a third party. The buyer now sues, and seeks to measure damages by the difference between contract price and market price. Assume, as is probable, that no other 1998 Schwabe SR81 150-ton die press was sold in Las Vegas on that day. Then the court might extrapolate from the prices of 1998 Schwabe SR81 150-ton die presses sold at roughly comparable times in roughly comparable locations, if such sales occurred. Even if such sales did occur, however, it is extremely unlikely that the die presses involved would be identical or even highly comparable in condition to the die press the seller agreed to deliver to the buyer. Or suppose, as is likely, that no 1998 Schwabe SR81 150-ton die presses were sold at roughly comparable times in roughly comparable places. Then the market price of a Schwabe SR81 150-ton die press might be extrapolated from roughly contemporaneous sales of Schwabe SR81 150-ton die presses manufactured in 1997 or 1999, or even from sales of other Schwabe models or perhaps other makes of die press. The market-price construct that is derived from such extrapolations may be much lower than the buyer's value for the Schwabe 1998 SR81 150-ton die press that he contracted to purchase. This could occur, for example, because that die press suited the buyer's needs better than comparable but different used die presses, or because the buyer had experience with that model die press but not with the makes and models of other used die presses sold around March 1.

In such cases, which are likely to be common, there is a significant likelihood of systematic undercompensation if damages are based on a market-price construct rather than on the buyer's valuation. Buyers will typically contract to pay a price that is less than their valuation (otherwise they would not buy), but will rarely if ever contract to pay a price that exceeds their valuation. Accordingly, buyers' valuations of differentiated commodities will

systematically exceed market prices, and damages based on the difference between the contract price and the market price of such commodities will be systematically undercompensatory.

If, in the context of the Resale Paradigm, the market price was measured by the resale price, it would be less expensive to establish the market price, and somewhat more likely that market-price damages would be compensatory. However, courts often treat a resale price as evidence, but only evidence, of market price.[21] Indeed, if the market price was normally measured by the resale price, there would be nothing left to the theory of efficient breach in the context of the Resale Paradigm, because a seller's profit from a resale would always be captured by the buyer under the market-price measure, and the seller therefore would have no incentive to resell.

Incidentally, this raises the following question: It is a premise of the Resale Paradigm that the buyer is entitled to damages at least equal to the difference between the contract price and the market price. Accordingly, the seller cannot make a profit on resale, net of the buyer's damages, unless the third party pays a price that exceeds the commodity's market price. But why would a third party pay a price above market? Within the parameters of the theory of efficient breach, normally that can happen for one of two reasons.

First, a constructed market price is likely to be the mid-point in a range of prices paid in comparable transactions, and the third party may have paid a price above the mid-point. In that case, there is grave doubt whether the third party really values the commodity more highly than the buyer. At the time of the sale to the third party, the buyer himself might have been willing to pay a price for the commodity that was above the mid-point of the range. Nothing efficient here.

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[21] *See, e.g.*, Dehahn v. Innes, 356 A.2d 711, 724 (Maine 1976); *See, e.g.*, Grummel v. Hollenstein, 90 Ariz. 356, 367 P.2d 960 (1962); Kemp v. Gannett, 365 N.E.2d 1112 (Ill. App. 1977); Reed v. Wadsworth, 553 P.2d 1024, 1036 (Wyo. 1976); *cf.* Triangle Waist Co. v. Todd, 119 N.E. 85 (1918); Murphy v. Lifschitz, 183 Misc. 575, 577, 49 N.Y.S.2d 439, 441 (1944), *aff'd mem.*, 294 N.Y. 892, 63 N.E.2d 26 (1945).

Second, the commodity may have a strategic value to the third party that is higher than its value to anyone else, and the constructed market price may not impound that strategic value. There is little or no evidence that this explanation accounts for many cases. Putting that aside, this explanation calls into question the meaning of market price. Shouldn't the market price of a commodity be the highest price that it would fetch on the market? In that case, if some buyer places a value on a commodity that is higher than the value of the commodity to any one else, why shouldn't that be the market price? If market-price damages are not measured that way, they do not compensate the buyer for the price that the contracted-for commodity could actually fetch on the market. If market-price damages are measured that way, there would be nothing left to the theory of efficient breach, because within the parameters of the theory the seller would have no incentive to re-sell to the third party.

(c) *Lost profits.* In addition to or in lieu of market-price (or cover) damages, a buyer may sue to recover profits lost as a result of the breach. Recovery of lost profits, however, is also undercompensatory, because of the certainty rule and the principle of *Hadley v. Baxendale.*

(1) *The certainty rule.* It is a well-established rule of contract law that damages must be proved with reasonable certainty. Under this rule, it is not enough for the plaintiff to show that it was probable that he suffered a loss as a result of breach. Instead, he must prove the *amount* of this loss with sufficient certainty. Damages that fail this test are often said to be "speculative." In practice, the certainty rule is usually applied to cut off damages resulting from buyer's lost profits. For example, a manufacturer who contracts to purchase component parts under a just-in-time inventory system may have no problem showing that he had some loss of profits from nondelivery, but may have enormous problems in establishing his loss in a way that satisfies the certainty rule.

The meaning of the certainty rule lies more in its application than in its formulation, because the rule leaves open the degree of certainty that is required. Often the courts set the degree of certainty required at a very high level, with little or no sensitivity to conceptions of probability. The certainty rule then leads to undercompensation. For example, in *Kenford Co. v. County of Erie*,[22] Erie County entered into a contract with Kenford and its affiliate, Dome. Under the contract, the County agreed to construct a Stadium and to either lease it to Dome for forty years or, if the parties could not agree upon the terms of a lease, to enter into a twenty-year Management Agreement with Dome. The terms of the Management Agreement were stated in the contract. Under those terms, Dome would manage the Stadium and the County would receive a stated percentage of gross revenues from Stadium operations. The Stadium was never constructed, because the County breached the contract after it became apparent that it had significantly underestimated the cost of construction. Dome sued the County for breach. To establish damages, Dome presented statistical projections of the profits that it would have made under the Management Agreement.

At the trial, Dome recovered a verdict for $25.6 million. The New York Court of Appeals reversed. Although the Court admitted that "the procedure for computing damages selected by Dome is in accord with contemporary economic theory and was presented through the testimony of recognized experts" and that "[t]he quantity of proof is massive and, unquestionably, represents business and industry's most advanced and sophisticated method for predicting the probable results of contemplated projects," the Court held that the proof was insufficient:

> [D]espite the massive quantity of expert proof submitted by [Dome], the ultimate conclusions are still projections, and as employed in the present day commercial world, subject to adjustment and modification. We of course

[22] 493 N.E.2d 234 (N.Y. 1986).

> recognize that any projection cannot be absolute, nor is there any such requirement, but it is axiomatic that the degree of certainty is dependent upon known or unknown factors which form the basis of the ultimate conclusion. Here, the foundations upon which the economic model was created undermine the certainty of the projections. . . . Quite simply, the multitude of assumptions required to establish projections of profitability over the life of this contract require speculation and conjecture, making it beyond the capability of even the most sophisticated procedures to satisfy the legal requirements of proof with reasonable certainty.

Kenford County reflects a nonprobabilistic approach to the certainty rule, which often results in undercompensation, partly because the level of required certainty is unduly high, and partly because this approach fails to recognize that contractual rights have value even if the value is probabilistic. In *Kenford County*, for example, Dome owned a financial asset—its economic rights under the Management Agreement. Like many such assets, this asset was risky. The fact that a financial asset is risky itself does not render the asset valueless. Rather, the riskiness of an asset is impounded into its expected value—the value of the asset based on a probability-weighted average of the various levels of profits that the asset will generate—a 10% probability of earning $7 million, a 20% probability of earning $4 million, and so forth. To make Dome indifferent between performance and breach, the Court should have awarded that expected value. Although some courts have adopted a modern, probabalistic approach to the certainty rule, the use of the restrictive approach employed in *Kenford* is not unusual.[23] Application of such an approach is a further reason why expectation damages are systematically undercompensatory.

(2) *The principle of Hadley v. Baxendale.* In the great case of *Hadley v. Baxendale*,[24] the Exchequer Chamber held that a party injured by a breach of contract can recover only those damages that either should "reasonably be considered . . . as arising naturally, i.e., according to the usual course of things" from the breach, or might "reasonably be supposed to have been in

[23] *See, e.g.*, Schonfeld v. Hillard, 218 F.3d 164 (2d Cir. 2000); Evergreen Amusement Corp. v. Milstead, 112 A.2d 901 (Md. 1955).
[24] 9 Exch. 341 (Exch. 1854).

the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it." The two branches of the court's holding have come to be known as the first and second rules of *Hadley v. Baxendale*.

On the basis of the two rules, contract law conventionally distinguishes between general damages, on the one hand, and consequential damages, on the other.

General damages are the damages that flow from a given type of breach without regard to the buyer's particular circumstances. These damages are never barred by the principle of *Hadley v. Baxendale*, because by their very definition they should "reasonably be considered . . . [as] arising naturally, i.e., according to the usual course of things from the breach." For example, if a seller breaches a contract for the sale of goods, it follows naturally that the buyer suffers damages at least equal to the difference between the contract price of the goods and their market price at the time of breach.

Consequential damages are damages that flow from the promisee's particular circumstances. Typically, consequential damages consist of the difference between (i) the post-breach profits that a promisee-buyer actually makes and (ii) the profits that the buyer would have made if the seller had performed. In the die-press hypothetical, for example, consequential damages would be the difference between the profits the buyer earned on his actual post-breach output and the profits he would have earned if the die press had been furnished as promised.

The second rule of *Hadley v. Baxendale* has traditionally been conceptualized to mean that consequential damages can be recovered only if, at the time the contract was made, the seller had reason to foresee that the damages would be the likely result of breach. Under this conceptualization of the second rule, the first rule is simply a special case of the second: if a given type of damage arises "naturally, i.e., according to the usual course of things" from a

breach (the first rule), then a promisor will always have reason to foresee that the given type of damages are the likely result of the breach (the second rule). Therefore, in the balance of this Article I will refer to this conceptualization of the second rule as *the principle of Hadley v. Baxendale*.

The bite of this principle is most easily illustrated by comparing its operation with the principle of proximate cause, which governs damages in almost every area of law except contracts. The difference between the two principles is not that the principle of *Hadley v. Baxendale* includes an element of foreseeability and the principle of proximate cause does not. Under the ascendant conception of proximate cause, that principle is also based on foreseeable risks, except perhaps for personal injuries that result from a tortious impact. The difference between the two principles therefore lies in two other elements.

First, the two principles require different degrees of likelihood. Under the principle of proximate cause, a wrongdoer will be liable if the injury that occurred was foreseeable at even a relatively low level of likelihood. In contrast, under the principle of *Hadley v. Baxendale* the degree of required likelihood was traditionally very high. Originally, a consequential loss could only be recovered if it was more probable than not. Under modern law, that level has decreased, so that "reasonably likely" or some similar test probably suffices.[25] Nevertheless, the degree of likelihood required under the principle of *Hadley v. Baxendale* undoubtedly remains higher than the degree of likelihood required under the principle of proximate cause.

Second, under the principle of proximate cause the issue is what risks of loss to the promisee were foreseeable to the wrongdoer at the time of the wrong. In contrast, under the principle of *Hadley v. Baxendale* that issue is irrelevant. Instead, the issue is what risks of loss to the promisee were reasonably foreseeable to the promisor at the time the contract was made.

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[25] *See* Koufos v. C. Czarnikow, Ltd. [The Heron II], [1969] A.C. 350 (H.L. 1967).

Indeed, for that reason the principle of *Hadley v. Baxendale* can bar damages even for losses that the promisor foresaw with certainty at the time of breach, if those damages were not reasonably foreseeable at the time the contract was made.

As a result, the theory of efficient breach and the principle of *Hadley v. Baxendale* are diametrically opposed. Under the theory of efficient breach, the promisor's decision to perform or breach should depend on a comparison of the promisor's gains from breach with the promisee's losses from breach as those gains and losses appear at the time of the perform-or-breach decision. In contrast, under the principle of *Hadley v. Baxendale*, in making a perform-or-breach decision a promisor, acting in her own interest, can disregard losses that she reasonably foresees or even knows that the promisee will incur from breach, as long as the risk of those losses became reasonably foreseeable to the promisor only after the contract was made.[26] Given this element, and the relatively high degree of likelihood required under the principle of *Hadley v. Baxendale*, that principle both conflicts with the theory of efficient breach and results in undercompensatory damages.

(d) *Pre-judgment interest*. If a contract is performed the promisee will have the use of his gains from and after the time of performance. In contrast, if a contract is breached the promisee loses the time value of those gains (the "lost gains") during the period from the time at which performance was due until the time of judgment (the "pre-judgment period"). Accordingly, to make a promisee indifferent between performance and breach, damages should include the time

[26] There is a limited exception. Where a carrier fails to make delivery after a shipment has reached its destination and nothing except delivery remains to be done, the carrier is responsible for the consequential damages it was then informed would likely result from breach. In Turner's Farms, Inc. v. Maine Central Railroad, 486 F. Supp. 694, 699-700 (D. Me. 1980), the court stated that this special rule is a "well-established common law exception to the rule of Hadley v. Baxendale." The court continued: "The rationale for the special rule is that after a shipment has reached its destination point the risks of actual shipment are complete, and when notice of special circumstances is given at this point, the carrier is capable of taking the necessary precautions to avoid negligent delay of delivery." *Id*. at 700.

value of the promisee's lost gains during the pre-judgment period, measured by compound interest on the amount of the lost gains at the rate the promisee pays for borrowed funds.

The general rule of law is that pre-judgment interest will be awarded only if the amount of the plaintiff's loss is "liquidated," that is, certain or at least reasonably ascertainable in amount.[27] The traditional counterpart contract-law rule, embodied in *Restatement Second* § 354, is that prejudgment interest on a recovery for breach of contract is recoverable as a matter of right if the breach consists of a failure to pay a definite sum in money or to render a performance with fixed or ascertainable monetary value, but that otherwise the award of prejudgment interest is discretionary. This rule is exemplified by the following Illustration:

> A sells seed to B, warranting that it is Bristol cabbage seed. Its is an inferior type of cabbage seed instead, and B suffers a loss of profit. B sues A and recovers $10,000, the difference between the value to B of a crop of Bristol cabbage and the crop actually grown. That amount was not, however, sufficiently definite to give B a right to interest on it. The allowance of interest is in the discretion of the court.

It has been said that the trend is to award prejudgment interest in contracts cases even where damages are unliquidated, [28] but not all cases take that position, [29] and some courts deny prejudgment interest in contract cases whenever the claim is unliquidated.[30]

Furthermore, even when pre-judgment interest is allowed, it is often not compounded.[31] Moreover, interest is often computed on the basis of an artificially low statutory rate,[32] such as

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[27] *See*, 1 D. DOBBS, *supra* note xxx, § 3.61(1).
[28] Council on Judicial Administration, *Report in Support of Pre-Verdict Interest in Personal Injury Cases*, 55 THE RECORD 496 (July/August 2000), citing Funkhouser v. J.B. Preston Co., 290 US 163, 168 (1933) (holding that pre-judgment interest is proper in contract actions, even if damages are unliquidated, "to secure more proper compensation").
[29] *See* Buono Sales, Inc. v. Chrysler Motors Corporation, 449 F.2d 715, 723 (3d Cir. 1971) (holding that a successful plaintiff in an action for breach of contract is not entitled to prejudgment interest as a matter of right where damages are unliquidated).
[30] *See, e.g.*, Black Gold Coal Corporation v. Shawville Coal Company, 730 F.2d 941 (3d Cir. 1984).
[31] *See, e.g.*, Big Bear Properties v. Ghermann, 95 Cal App 3d 908 (1979).
[32] *See, e.g.*, ILL. ANN. STAT. ch. 815, para. 205/2 (Smith-Hurd 1993).

the interest rate on United States Treasury Bills,[33] which is typically well below the market rate of interest for most borrowers.[34] Accordingly, as Posner himself recognized in *Patton v. Md. Continent Systems*,[35] expectation damages are often less than compensatory because of pre-judgment interest is either not awarded or is too low.

(e) *Summary*. The analysis in this section can be summarized as follows: As a result of a cluster of rules that govern expectation damages—including the rules that deny recovery for the cost of obtaining compensation, the way in which market-price damages are calculated, the certainty rule, the principle of *Hadley v. Baxendale*, and the rules governing prejudgment interest—expectation damages are systematically undercompensatory in terms of the indifference conception.

Of course, the validity of the theory of efficient breach might look different if damages were measured in a way that made promisees truly indifferent between performance and breach. However, the theory is presented as a theory about the present world, rooted in positive law, and therefore needs to be evaluated under present-world, positive-law conditions. Furthermore, although some of the rules that result in undercompensation might be easily fixed, others are justifiable and deeply embedded. For example, the American rule, under which each party bears his own costs of litigation, has strong normative support, and it is widely (although not universally) believed that the principle of *Hadley v. Baxendale* has positive efficiency

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[33] *See*, McCrann, 803 F.2d at 774 (approving award of pre-judgment interest in admiralty case based on six-month Treasury bill rates); ECDC Envtl. L.C. v. New York Marine & Gen Ins. Co., 1999 US Dist LEXIS 9836 (BSJ) (S.D.N.Y. 1999) (applying interest rate paid on six-month Treasury Bills); Barwil ASCA v. M/V SAVA, 44 F. Supp. 2d 484, 489 (E.D.N.Y. 1999); Zim Israel Navigation, 29 F. Supp. 2d at 193-94 (same); Weeks Marine, Inc. v. John P. Picone, Inc., 1998 U.S. Dist. LEXIS 15053, at *24-25, 97 (S.D.N.Y. 1998) (applying 12 month average Treasury Bill rate); MICH. COMP. LAWS § 600.6013(6) (West Supp. 1994) (except for judgments on written instruments, "interest on a money judgment recovered in a civil action shall be calculated at 6-month intervals from the date of filing the complaint at a rate of interest that is equal to 1% plus the average interest rate paid at auctions of 5-year United States treasury notes during the 6 months immediately preceding July 1 and January 1").

[34] *See* Michael S. Knoll, *A Primer on Prejudgment Interest*, 75 TEX. L. REV. 293, 315 (1996).

[35] 841 F.2d 742 (7th Cir. 1988).

consequences. Finally, even if all the rules that presently result in undercompensation were changed, it is highly unlikely that contract law could ever make a promisee perfectly indifferent between performance and damages, because such factors as of the impracticability of putting a money value on the importance of reliability, the difficulty of measuring a promisee's subjective valuation, and the risk of the promisor's insolvency between the time of breach and the time of judgment.

Accordingly, the compensation predicate of the theory of efficient breach, like the information predicate, is incorrect. In contrast, the compensation predicate is normally satisfied through efficient termination that occurs by mutual consent, because the buyer normally will not consent to termination unless the seller pays him an amount that he regards as compensatory.

4. *Efficiency*. The failure of the information and compensation predicates is sufficient to invalidate the theory of efficient breach in the context of the Resale Paradigm. In addition, however, in the context of this Paradigm the theory lacks an efficiency justification.

The standard efficiency justification of the theory of efficient breach in this context is that presented by Posner in the first edition of *Economic Analysis of Law*: If a seller's gain on breach and resale exceeds the buyer's loss, breach is an instrument for transferring a commodity to a higher-valued use. The validity of this justification cannot be established.

Consider first a resale in a world in which there are no transaction costs. In such a world the higher-valued-use rationale would clearly be incorrect. Under a straightforward application of the Coase Theorem (in the absence of transaction costs the efficient outcome will occur without regard to the content of legal rules), if the third party values the commodity more than the buyer, he will end up with the commodity even under a performance-oriented regime. Indeed, as Dan Farber dramatically puts it, in a world without transaction costs, if the third party

has a higher valued use for a commodity than the buyer, he will end up with the commodity even if sellers never breach, because breach is a capital offense:

> [Assume that] B, a buyer, and S, a seller, contract for the production of unique goods. Before the delivery date, X (a third party) offers to buy the goods from S. Assum[e] zero transaction costs. . . .
>
> . . . To take the most extreme case, suppose that breach of contract were a capital offense. S would not be willing to breach even if X offered to pay far more than the goods are worth to B. X would still ultimately receive the goods, however, as X would either pay B to assign him the contract or buy the goods from B after delivery. Absent transaction costs, no assignment of liability will prevent the parties from achieving this distribution of goods.[36]

In short, in a world without transaction costs, commodities always flow to higher-valued uses. But commodities will normally flow to higher-valued uses even in a world *with* transaction costs and universal specific performance. In such a world, if a third party values the commodity more than the buyer, and knows the buyer's identity, he will purchase from the buyer either an assignment of the contract or the commodity itself. If the third party does not know the buyer's identity, then if the seller is economically rational she will either negotiate with the buyer for a release from the contract, or will sell the third party's identity to the buyer or the buyer's identity to the third party.

In the end, therefore, in the context of the Resale Paradigm, Posner's efficiency justification of the theory of efficient breach is not that breach will move commodities to higher-valued uses. Rather, it is that the transaction costs of moving commodities to a higher-valued use will be less under an efficient-breach regime than under a performance-oriented regime. After all the shouting is over, therefore, Posner's efficiency justification is based exclusively on saving transaction costs.

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[36] Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1449-50 (1980).

Posner deemphasized this fact, but he was aware of the problem. In an attempt to deal with it, in the first edition of *Economic Analysis of Law* Posner added two cursory sentences at the end of his custom-ground-widgets illustration: "To be sure," Posner says, "had I [the seller] refused to sell to B [the third party], he could have gone to A [the buyer] and presumably negotiated an assignment of part of A's contract with me to him. But this would have introduced an additional step and so imposed additional transaction costs."[37]

Choices among competing legal regimes that purport to be based on small transaction costs usually rest on very shaky foundations. Often transaction costs are trivial, and as Paul Mahoney observes, "The transaction costs approach yields . . . no persuasive conclusion when transaction costs are low (unless we can measure them with extreme precision)."[38] Even where transaction costs are more than trivial, it is frequently impossible to reliably identify and quantify all the transaction costs of alternative legal regimes. As Ian Macneil has pointed out, "it is extremely easy to introduce selected transaction costs to show that the model 'proves' what the modeler wants it to prove, while ignoring countless other transaction costs of equal or greater pertinence in the real world—costs yielding different conclusions."[39] Often, therefore, transaction-cost arguments adorn rather than control a preference for one legal regime over another.

That is exactly the way Posner used transaction costs in the first edition of *Economic Analysis of Law*. Posner argued that if the third party had a higher-valued use for the commodity than the buyer, and the law required the seller to perform, there would be a transaction cost for negotiating an assignment of the buyer's rights under the contract to the third party. He failed to point out, however, that a resale also entails transaction costs.

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[37] POSNER, *supra* note xxx, at 122.
[38] Paul G. Mahoney, *Contract Remedies and Option Pricing*, 24 J. LEG. STUD. 139, 142 (1995).
[39] Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 962 (1982).

To begin with, a seller and a third party will incur search costs to find each other, and after they have found each other they will incur the cost of negotiation.[40] The costs of negotiation between (i) the seller and the third party, and (ii) the buyer and the third party, will normally wash. However, the cost of search in an efficient-breach regime will have no counterpart in a performance-oriented regime. Furthermore, if the seller breaches she must compensate the buyer, and since the buyer's damages will normally be both uncertain and contested, compensation of the buyer in an efficient-breach regime will require costly negotiation and often costly legal fees.

Ian Macneil and Daniel Friedmann have shown that it is impossible to definitively establish whether the transaction costs of moving commodities to higher-valued uses would be greater under an efficient-breach or a performance-oriented regime.[41] If, however, we model this problem using the most likely and significant costs—the costs of negotiation, search, and dispute-settlement—then given that negotiation costs are a wash, and that an efficient-breach regime involves the extra costs of search and dispute-settlement, the transaction costs of that regime would be significantly higher than the transaction costs of a performance-oriented regime.

Presumably under the impetus of critiques like those of Friedmann and Macneil, beginning in the third edition of *Economic Analysis of Law* Posner reworked his transaction-costs passage to concede that breach, as well as performance, entailed transaction costs:

> True, if I [the seller] had refused to sell to B [the third party], he could have gone to A [the buyer] and negotiated an assignment to him of part of A's contract with me. But this would have introduced an additional step, with additional transaction

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[40] James Gordley, *A Perennial Misstep: From Caetjen to Fuller and Perdue to "Efficient Breach,"* [2001] ISSUES IN LEGAL SCHOLARSHIP, Article 4.

[41] *See* Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEG. STUD. 1 (1989); Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 950-51 (1982).

> costs—and high ones, because it would be a bilateral-monopoly negotiation. On the other hand, litigation costs would be reduced.[42]

The grudging nature of this concession is evidenced by its somewhat misleading nature. Posner stated that negotiation between the buyer and the third party would be costly because the negotiating parties would be in a bilateral monopoly. He did not point out, however, that efficient-breach regime negotiation between the seller and the third party would also involve a bilateral monopoly. Furthermore, Posner persisted in failing to point out that in an efficient-breach regime there will be costs for search and contracting between the seller and the third party. Finally, Posner stated that "litigation costs would be *reduced* in a performance-oriented regime," as if there were litigation costs under both regimes, but they were lower under a performance-oriented regime. Of course, it is not the case that there are litigation costs in both regimes. If performance occurs, there are no litigation costs.

In short, a comparative-transaction-cost analysis does not provide an efficiency justification for the theory of efficient breach in the context of the Resale Paradigm. Furthermore, there is no reason to believe that the third party has a higher-valued use for the commodity than the buyer. It is true that the amount that the third party offers to pay now is, by hypothesis, greater than the amount that the buyer negotiated to pay earlier, but as shown above,[43] this tells the seller little or nothing about the parties' respective valuations. Indeed, in the context of the Resale Paradigm the seller may breach and sell the commodity to the third party even if she *knows* that the value the third party places on the commodity is less than the buyer's value, because even if she knows that, she will also know that because of the costs of litigation and the undercompensatory nature of damages, the buyer may choose not to sue.

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[42] RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 107 (3d ed. 1986).
[43] *See* text at note xxx, *supra*.

Accordingly, there is no reason to believe that a resale will move a commodity to a higher-valued use more often than it will move a commodity to an equally-valued or lower-valued use. Perhaps for these reasons, in the third edition of *Economic Analysis of Law*, Posner changed the rhetoric of his efficiency justification from higher-valued use to Pareto superiority:

> Having obtained an additional profit of $1,250 on the sale [of the widgets to B, the third party, I (the seller)] am better off even after reimbursing A [the buyer] for his loss, and B is no worse off. The breach is Pareto superior, *assuming that A is fully compensated* and no one else is hurt by the breach.[44]

In the context of the Resale Paradigm, however, the Pareto-superiority justification is no more persuasive than—and indeed just a variant of—the higher-valued-use justification. Posner's conclusion explicitly turns on the assumption of full compensation, and that assumption does not hold, if by compensation is meant the amount required to make a promisee indifferent between performance and breach. Because the assumption does not hold, although the seller will be better off from breach, the buyer will be worse off. Indeed, breach would not be Pareto superior even if Posner's compensation assumption did hold. Even with full compensation for his losses the buyer is worse off in the breach state than in the performance state, because in the breach state he loses the higher price that the third party is willing to pay.

5. *Efficiency costs of the theory of efficient breach*. In the context of the Resale Paradigm, then, the theory of efficient breach has little or no efficiency benefits. On the contrary, if the theory was widely followed it would entail three kinds of efficiency costs. The theory would inefficiently remake parties' contracts; it would inefficiently provide disincentives for planning; and it would reduce the efficiency of the contracting system.

(a) *Inefficiently remaking parties' contracts*. One way to measure the efficiency of a contract rule is to ask what rule well-informed contracting parties would normally adopt if

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[44] POSNER, *supra* note xxx, at 137 [3d ed.] (emphasis added).

bargaining were costless. This is not the only way to measure the efficiency of a contract rule. Furthermore, the answer to this question will often be indeterminate. Nevertheless, the question is worth pursuing, because all things being equal, it can normally be assumed that parties are the best judges of their own utility, so that if the great majority of well-informed contracting parties would favor one rule over another, that rule normally would be the most efficient.

There is an easy test for determining whether the theory of efficient breach corresponds to the rule that contracting parties in the Resale Paradigm would normally agree to at the time the contract is made, if they addressed the issue. Suppose that Seller and Buyer have negotiated a contract under which Seller agrees to sell a differentiated commodity to Buyer—say, a home to live in, custom-made widgets that Buyer will use as an input in production, or a used die press that Buyer will use as a factor of production. As the parties are about to sign a written contract, Seller tells Buyer, "In all honesty, I should tell you that although I have no present intention to breach this contract, neither do I have a present intention to perform. If a better offer comes along, I will take it and pay you expectation damages. In fact, I will begin actively looking for a better offer right after we sign this contract. Let's insert a provision that says just that." What would be Buyer's likely response? Under the theory of efficient breach, Buyer would say, "Of course, I expect no more." In reality, most buyers would be surprised if not shocked by such a statement, and would either walk away; insist on explicit contractual provisions stating that the seller has a present intent to perform and that any profit on breach and resale will go to buyer; or demand a payment, in the form of a lower price, for the seller's right to resell. Indeed, a person who makes a promise with an intent to *not* perform is guilty of promissory fraud, because a promisor makes an implied representation that he has no such intent.[45] As Ian Ayres and

[45] *See, e.g.,* Price v. Highland Community Bank, 722 F.Supp. 454 (N.D. Ill. 1989) (Posner, J.).

Gregory Klass have concluded, a promisor also normally makes an implied representation that she has an intent *to* perform.

> If we believe [Holmes's aphorism that "the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, - and nothing else" [46]], then every contractual promise is no more than a take-or-pay contract, giving the promisor the option to perform or pay damages. And if this is so, why think a legally enforceable promise represents an intent to perform—rather than an intent to perform or pay damages?
>
> Now we doubt whether such an approach is correct, either as a matter of everyday semantics or as a matter of best legal practices. For one thing, it doesn't conform to our intuitions about everyday promissory practice—whether the context be a personal, extra-legal promise or an arms-length transaction. For another, we think that there are good reasons why promisors want to implicitly say that they intend to perform *simpliciter*, rather than that they intend to perform or pay damages, or that they do not intend not to perform, or nothing at all about their intent. Promisees care about promisor intent because they care deeply about whether or not the promisor will perform. If a promisee thinks that the promisor doesn't intend to perform, but that she is seriously considering the option of paying damages instead, he is much less likely to rely on her promise—be it by entering into a binding contract or by otherwise ordering his behavior with expectation of performance. But the whole point of promising is to convince others to rely on one's future actions. Thus promisors have a natural incentive to communicate with their promise an intent to perform it. This is why most promises represent an intent to perform and why the law should adopt a default interpretation that recognizes this fact.[47]

The conclusion that a contracting promisee normally expects that the promisor is committed to performance, rather than performance or damages at the promisor's election, is backed not only by experience and theory, but by empirical evidence. In 1990, David Baumer and Patricia Marschall surveyed 119 North Carolina corporations about their attitudes towards willful breach. One question was, "If a trading partner deliberately breaches a contract because a

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[46] Oliver W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457 (1897), *reprinted in* 110 HARV. L. REV. 991, 995 (1996-1997). For more on Holmes's aphorism, *see* n. xxx, *infra*.

[47] Ian Ayres & Gregory Klass, *Promissory Fraud Without Breach*, ___ WISC. L. REV. ___ (MS. pp. 10-11) (Forthcoming 2004). Ayres and Klass add, "That said, . . . in some contexts a promise may not say that the promisor intends to perform, but—like the purchase of an option—only that she does not intend not to perform. Thus a law-school applicant who has not yet heard from her first choice but pays a non-refundable deposit to her safety school does not misrepresent her intent to enroll, for her promise does not say that she presently intends to intend." *Id* at [MS. p. 11]. The force of this possible counter-example is not clear, since the applicant does not seem to have made a promise.

better deal can be had elsewhere, is such behavior unethical?" One hundred and five respondents said yes.[48] These responses can be explained only if buyers understand a contract of sale as a commitment by the seller to performance, not as a commitment to perform or pay damages at the seller's option.

We can see why buyers would have such an understanding by examining in more detail the reasons that motivate the relevant contracting behavior. In the context of the Resale Paradigm, the theory of efficient breach applies only if a buyer and a seller have made a forward contract for delivery of a differentiated commodity at a future time, and thereafter a third party offers to purchase the commodity for more than the contract price. Why might a buyer prefer to make a forward contract for the acquisition of a differentiated commodity, rather than buying on the spot market when he needs delivery?

One reason to make advance commitments is to lock in a price, by shifting the risk of price changes to the seller. As Richard Craswell has pointed out, a buyer may want to lock in a price if he is risk averse. If the seller is less risk averse than the buyer, then "the minimum amount that the seller must be paid to take the risk of a market fluctuation on herself will be less than the maximum [amount that the buyer] will willingly pay to be relieved of the risk,"[49] so that there is a range in which surplus can be generated if the seller takes the risk. Or, the buyer and the seller have different forecasts of the likelihood of an overbid. If the seller thinks the likelihood of a rise in price is very low, he will want to make a forward contract to lock up the

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[48] David Baumer & Patricia Marschall, *Willful Breach of Contract for the Sale of Goods: Can the Bane of Business be an Economic Bonanza?*, 65 TEMP. L. REV. 159, 165-66 (1992). In addition, eighty-six said that they would always or almost always withhold future business from a party who had willfully breached. *Id.*

[49] Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 STAN. L. REV 481, 488 (1996).

buyer's price. If the buyer thinks the likelihood of a rise in price is very high, he will want to make a forward contract to lock up the seller's price.[50]

Often, a buyer who contracts to purchase differentiated goods has a more complex objective. As John Rawls observes:

> The role of promises is analogous to that which Hobbes attributed to the sovereign. Just as the sovereign maintains and stabilizes the system of social cooperation by publicly maintaining an effective schedule of penalties, so men in the absence of coercive arrangements establish and stabilize their private ventures by giving one another their word.[51]

Applying that observation to the context at hand, buyers who contract for the purchase of a differentiated commodity often do so not, or not only, to shift the risk of price changes, but to coordinate and stabilize their planning and production, either by locking in the supply of inputs and factors of production, even without shifting the risk of price changes, or by locking in supply and price jointly, with the emphasis on locking in supply. Locking in the supply of given inputs and factors of production allows buyers to confidently engage in long-term production projects and to make expenditures on contract-specific and wealth-enhancing reliance, such as advertising and the acquisition of control over complementary inputs and factors of production. Often, therefore, contracts do not shift the risk of price changes—examples are cost-plus contracts and long-term requirements contracts where the price is the seller's posted price at the time of delivery. Even where allocation of the risk of price changes is an important purpose of a contract, the buyer's need to acquire control over inputs and factors of production is often equally or more critical. An example is a contract for just-in-time delivery of manufacturing components, where delays in delivery would ordinarily be much more adverse than price

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[50] *Id*. at 488.
[51] J. RAWLS, A THEORY OF JUSTICE, 342-47 (1971).

increases.[52] As stated in the Comments to the U.C.C., "the essential purpose of a contract between commercial [actors] is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit." Accordingly, "a continuing sense of reliance and security that the promised performance will be forthcoming when due . . . is an important feature of the bargain."[53]

A buyer who wants to achieve stability of price and supply must pay for doing so. Call a third party who offers to buy a differentiated commodity that is already under contract an *overbidder*, and call his offer an *overbid*. At the time when a contract for the sale of a differentiated commodity is entered into, the buyer and the seller will almost invariably know that an overbid might be made. As Alan Schwartz states:

> [Markets for differentiated goods] often are well organized; the antique market provides an example. Such markets have two distinguishing features. First, they are usually characterized by greater price dispersion than obtains in the market equilibria for roughly fungible goods. In addition, sellers of [differentiated] goods face a lower "rate of arrival" of potential buyers than do sellers of roughly fungible goods. These two phenomena are related; a high "buyer arrival" rate implies extensive comparison shopping among firms, whereas the degree of price dispersion a market can sustain varies inversely with the amount of comparison shopping. [As a result, a seller of differentiated] goods consequently has grounds to believe that the offers he receives are to some extent random, and that later offers could be much higher than earlier ones.[54]

Moreover, contracting parties can place an expected value on the prospect of an overbid, based on a weighted average of potential overbid prices, giving effect to the probability that an overbid will be made at each price.

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[52] 3 GEORGE E. PALMER, THE LAW OF RESTITUTION § 15.9 at 440-41 (1978) ("In most contracts, . . . [t]he expectation that deserves protection is the promised performance, which the promisee desires for a multitude of reasons that may have nothing to do with whether it is worth more than he agreed to pay. . . .").

[53] U.C.C. § 2-609, Comment 1.

[54] Schwartz uses the term "unique," rather than "differentiated," but it is clear from his text that he is referring to non-homogeneous—that is, differentiated—goods. Alan Schwartz, *The Case for Specific Performance*, 89 YALE L. J. 271 (1979).

Because the buyer and the seller know that an overbid may be made, the buyer must pay the seller a premium for taking the risk of forgoing an overbid. Presumably, the amount of that premium will be closely related to the expected value of an overbid. Having been paid this premium, the seller should not be allowed to abrogate the insurance that she sold to the buyer, by selling to an overbidder and confiscating the value of the overbid. Making a forward contract for the sale of a differentiated commodity reflects a decision by the seller, embodied in a binding commitment, that her best bet is to take the buyer's bid rather than to wait for a higher offer. If the seller keeps searching for, or accepts, a higher offer, she is welching on her bet.

This point is forcefully made in *Greer Properties, Inc. v. LaSalle National Bank*.[55] In February 1987, the Sellers contracted to sell a parcel of real estate to Searle Chemicals for approximately $1,100,000. Searle had the right to terminate the contract if the soil was contaminated by environmental waste. An environmental consulting firm that Searle hired reported that the site was contaminated, and that a clean-up would cost more than $500,000. Searle asked the Sellers to reduce the contract price. The Sellers refused, and Searle exercised its right to terminate.

The Sellers then began negotiating with Greer Properties, a real-estate subsidiary of Marriott Corporation. In July 1987, the Sellers contracted to sell the property to Greer for $1,250,000. Under the contract the Sellers were required to remove the environmental contamination at their own expense, but under the clean-up provision the Sellers were allowed to terminate the contract if the cost of the clean-up became economically impracticable.

The Sellers then retained a soil consultant, who estimated the cost of the clean-up at $100,000 - $200,000. At that point, the Sellers went back to Searle and entered into a new round of negotiations. A purchase price of $1,455,000 was proposed in these negotiations, and Searle

[55] 874 F.2d 457 (7th Cir. 1989).

sent a draft contract to the Sellers. On the same day, the Sellers received a final report from a new soil consultant, who estimated the clean-up at $190,000 - $240,000. The next day, the Sellers terminated the contract with Greer, purportedly under the clean-up provision. Thereafter, the Sellers indicated that Greer could still buy the property if it increased the purchase price by $250,000. Greer declined to make the higher offer.

Greer brought an action for specific performance and damages. The district court held for Sellers, on the ground that upon receipt of the soil consultant's study, Sellers had broad discretion to terminate the contract under the clean-up provision. The Seventh Circuit reversed, on the ground that by making the contract with Searle, Sellers had given up their right to look for a better price:

> Under Illinois law, "every contract implies good faith and fair dealing between the parties to it." . . . This implied obligation of good faith and fair dealing in the performance of contracts acts as a limit on the discretion possessed by the parties. . . .
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> With this limitation on the discretion of the Sellers in mind, their decision to terminate the contract must be analyzed to determine if they acted in good faith. If the Sellers terminated the contract to obtain a better price from Searle, their action would have been in bad faith. *When the Sellers entered the contract with Greer and Greer agreed to pay them a specific price for the property, the Sellers gave up their opportunity to shop around for a better price*. By using the termination clause to recapture that opportunity, the Sellers would have acted in bad faith.[56]

Judge Posner joined the opinion.

As *Greer* holds, a contract for the sale of differentiated commodities implicitly prohibits a seller from searching for an overbidder or otherwise breaching to accept an overbid. Accordingly, the theory of efficient breach, which approves and indeed encourages such conduct, would inefficiently re-make contracts. To put this differently, in a contract for the sale of a differentiated commodity, the buyer contracts to purchase the commodity and the seller

[56] *Id*. at 460 (emphasis added).

contracts to deliver the commodity and to forgo the positive risk that an overbidder may come along. Whether that positive risk materializes before or after delivery is not relevant. Just as the buyer takes the burden of the negative risk that the objective or subjective value of the commodity may fall before or after delivery, so does the seller forgo the positive risk that the value of the commodity may rise before or after delivery. One element of the positive risk that the seller forgoes by making the contract is the opportunity of accepting an overbid.

In short, the proposition that a seller who has made a contract to sell a differentiated commodity has an option under the contract to either perform or pay damages does not ordinarily reflect the expectations of parties to such contracts. If we assume that parties are the best judges of their own utility, and that contracts are, for that reason, an instrument of efficiency, then the theory of efficient breach is inefficient because it re-makes the contract the parties make for themselves.

Of course, there may be cases where at the time the contract is made the buyer is willing to allow the seller to resell and to keep the gain from an overbid, in exchange for a lower price. These cases are easily dealt with. Where a seller wants the right to resell, in exchange for a reduction in price, and the buyer finds that deal to be attractive, the parties can achieve this result by explicit contract language that gives the seller that right and waives any right the buyer would otherwise have to seek specific performance or disgorgement.

(b) *Inefficient disincentives for planning*. The theory of efficient breach also provides inefficient disincentives for planning. Where the buyer's damages are based on the difference between contract price and market price, under the theory of efficient breach the seller will gain from breach only if the price paid by the third party exceeds the market price. Recall that there are two basic reasons why a third party may pay more than market price. First, market price is a

construct based on extrapolations from comparable transactions, and the third party may pay a price above the mid-point of comparable transactions. In that case the theory has no positive efficiency implication, because there is no reason to believe that the third party values the commodity more highly than the buyer. Second, the commodity may have a strategic value to the third party that is higher than its value to anyone else, and the constructed market price may not impound that strategic value.

However, if the third party had a special strategic need for the commodity when he made his overbid, he probably had a prospect of the strategic need when the original contract was made. The question then arises, why didn't the third party make a contract with the seller at that time? The answer to this question is likely to involve issues of foresight and investment. For example, it may often be that the commodity takes time to produce, and the buyer foresaw a future need for the commodity and was willing to invest in a contract for production of the commodity, at a time when the third party lacked the foresight, was unwilling to make the investment, or both. Or, it may often be that the commodity essentially consists of productive capacity, and the buyer foresaw a future need for that capacity, and was willing to invest in a contract to lock up that capacity, at a time when the third party lacked the foresight, was unwilling to make the investment, or both. In either type of case, the third party may be willing to pay more than the constructed market price because the supply or productive capacity that he needs has now become highly constrained. But providing the seller with an incentive to sell the commodity to the third party in either type of case would deny the buyer the benefit of his foresight and investment. Efficient incentives should be just the other way around. The law should reward the ant, not the grasshopper. It is the buyer who has earned the opportunity to acquire the commodity, by having foresight and investing when the third party was either not

smart enough or willing enough to do so. Accordingly, in such cases too, the theory of efficient breach would have efficiency costs, because it would diminish the incentives for developing foresight and investing. As stated by Doug Laycock:

> It is common ground that one economic function of contract is to allocate risk. One of the risks that is allocated by contracts is the risk of doing without in time of shortage. Those who plan ahead when shortage is merely a risk should reap the benefits when shortage comes to pass. . . . [B]reaching sellers should not be able to reallocate the risk after the fact by . . . keeping the specific thing and paying damages that cannot be used to replace it.[57]

(c) *Weakening the contracting system*. The theory of efficient breach is a static and short-run theory. It concerns the efficiency of performing or breaching an individual contract. A dynamic, long-run approach to the issue of breach would consider the efficiency of the contracting system taken as a whole. The theory of efficient breach is inefficient from this perspective, because if widely adopted it would diminish the efficiency of that system.

The efficiency of the contracting system does not rest, as the theory of efficient breach implies, solely on legal remedies. Rather, the efficiency of the contracting system rests on a tripod whose legs are legal remedies, reputational constraints, and the internalization of the moral norm of promise-keeping. The three legs are mutually supportive. Legal rules rest in significant part on social norms, reputational effects rest principally on social norms, and moral norms are reinforced by legal rules and supported by reputational effects.

Moreover, no single leg is alone sufficient to ensure the reliability of the contracting system. Legal rules are not alone sufficient, because dispute-settlement under law is expensive and chancy. The moral norm of promise-keeping is not alone sufficient, because not all actors fully internalize moral norms and there are limits on the power of norms. Reputational constraints are not alone sufficient, because these constraints are fully effective only if third

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[57] DOUG LAYCOCK, THE DEATH OF THE IRREPARABLE INJURY RULE 253-54 (1991).

parties have reliable knowledge concerning a promisor's history of breach. That knowledge is hard to come by, because many breaches do not become widely known, and many promisors claim that they had a valid excuse for not performing.

Because all three legs are necessary to support the efficiency of the contracting system, anything that weakens one leg seriously threatens the efficiency of the system. The theory of efficient breach, if widely adopted, would do precisely that, because the effect of the theory is to remove the moral force of promising in a bargain context. The moral meaning of making a promise is to commit yourself to take a given action in the future even if, when the action is due to be taken, all things considered you do not wish to take it. The theory of efficient breach turns this upside down. Under that theory if, when a promise is due to be kept, all things considered you do not wish to keep it, you needn't do so.

Indeed, removing the moral force of promises in a bargain context is not only an effect of the theory of efficient breach; it is a purpose of the theory. Robert Birmingham, who originated the theory, was explicit on this point:

> [P]rotection of the expectation interest . . . encourages optimal reallocation of factors of production and goods without causing material instability of expectations. More rigorous adherence to this standard would promote proper functioning of the market mechanism. Encouragement of repudiation where profitable through elimination of moral content from the contract promise might also be socially desirable.[58]

To the same effect, Posner states that if the seller's gain from breach will exceed the buyer's

[58] Robert L.Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273 (1970).

loss, then "if damages are limited to loss of expected profit, there will be an incentive to commit breach. *There should be*."[59]

Given the dilution or elimination of the moral force of promises under the theory of efficient breach, that theory, if widely adopted, would decrease the efficiency of the contracting system in three ways. First, it would increase the need to resort to litigation, which is very expensive, as opposed to achieving performance of contracts through the internalization of the moral norm of promise-keeping, which is very inexpensive. Second, it would lead contracting parties to make greater use of costly noncontractual measures to ensure performance, such as self-enforcing deposits. Third, it would diminish the force of reputational constraints, because reputational constraints rest in part on a moral basis.

Indeed, the rejection of the moral force of promises under the theory of efficient breach leads to an internal contradiction in the theory. Under the theory, a promisor should breach when her gains from breach will exceed the promisee's losses from breach. The claim is that where the theory is applicable, breach will efficiently increase social wealth. However, if the moral force of a promise is rejected, then a promisor's decision to perform or breach would not depend

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[59] POSNER, *supra* note xxx, at 120 (emphasis added). Somewhat similarly, Steven Shavell argues (incorrectly in my view, *see* text at notes xxx-xxx *infra*) that the theory of efficient breach merely reflects what the parties themselves would have agreed to if they had addressed the issue, and adds:

> This understanding of damage measures as a device to induce the behaviour that the parties would have specified in more complete contracts sheds light on the notion, held by many legal commentators, that contract breach is immoral, as it constitutes the breaking of a promise. That belief is often incorrect, it is submitted, and might fairly be considered to be the opposite of the truth. The view that a contract breach is the breaking of a promise overlooks the point that the contract that is breached is generally an incomplete contract, and that the breach is what the parties want and would have specified in a complete contract.

Steven Shavell, CONTRACTS, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 436, 439 (1998).

This passage is a little obscure. If Shavell means only that nonperformance of a contract is not immoral if it is permitted by an implied term of the contract, he is of course correct. There's nothing wrong with not performing a contract when the contract itself expressly or impliedly provides that performance is not required. Who could possibly think otherwise? But since that is a truism, presumably Shavell means something more. In particular, he seems to mean just what he says—that the theory of efficient breach teaches that "the notion . . . held by many legal commentators that contract breach is immoral . . . is often incorrect . . . and might fairly be considered to be the opposite of the truth."

on whether a breach increased social wealth, but on whether it increased the promisor's wealth. Once it is understood that a promisee's legal damages will be systematically less than his actual losses, the self-seeking promisor envisioned by the theory will ask herself, not whether her gains from breach exceed the promisee's losses, but whether her gains from breach exceed the promisee's legal damages. If they do, the promisor will breach even if her gains are less than the promisee's losses, so that social wealth is decreased.[60]

Posner eventually acknowledged this problem, at least tacitly, and modified his version of the theory of efficient breach by excluding "opportunistic" breaches from its scope. Here is the version of that exclusion in the fourth edition:

> It makes a difference in deciding which remedy to grant whether the breach was opportunistic. If a promisor breaks his promise merely to take advantage of the vulnerability of the promisee in a setting (the normal contract setting) where performance is sequential rather than simultaneous, we might as well throw the book at the promisor. An example would be where A pays B in advance for goods and instead of delivering them B uses the money in another venture. Such conduct has no economic justification and ought simply to be deterred. An attractive remedy in such a case is restitution. The promisor broke his promise in order to make money—there can be no other reason in the case of such a breach. We can deter this kind of behavior by making it worthless to the promisor, which we do by making him hand over all his profits from the breach to the promisee; no lighter sanction would deter.[61]

Later, wearing his judicial hat, Posner gave another example of opportunism:

> Not all breaches of contract are involuntary or otherwise efficient. Some are opportunistic; the promisor wants the benefit of the bargain without bearing the agreed-upon cost, and exploits the inadequacies of purely compensatory remedies . . . .[62]

In other words, Posner now states that in the case of opportunistic breach, the available remedies should not be limited to expectation damages, but should include disgorgement of the

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[60] *Cf.* Schwartz, supra note xx, at 291 ("promisors may sometimes breach when their gains from breach exceed the damages a court will assess, though not the full costs breach imposes on the promisees. Such breaches may be inefficient for they make promisors better off but promisees worse off.")

[61] RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 117-18 (4th ed. 1992).

[62] Patton v. Md. Continent Systems, 841 F.2d 742 (7th Cir. 1988).

promisor's gain. Posner exemplifies, but does not define, opportunistic breach. However, it's hard to avoid the conclusion that the concept of opportunism has a moral element, and that a deliberate breach of contract for the purpose of increasing the seller's gain—as opposed, say, to an inadvertent breach of contract or a breach to avoid an unexpected loss—is opportunistic in any normal sense of that term. Therefore, as Friedmann points out, the exception for opportunistic breach lets most of the remaining air out of the efficient-breach balloon, at least in the context of the Resale Paradigm.

> A distinction is [now drawn by Posner] between "opportunistic breach" and other breaches of contract. Breaches in the latter category still enjoy respectability and, if considered efficient, are lauded. Opportunistic breaches have lost the patronage of the efficient breach theory and are harshly denounced. The distinction is unsatisfactory and in fact undermines much of the efficient breach theory. Indeed, Posner states that the opportunistic contract breaker should be made to "hand over all his profits from the breach to the promisee." Recovery of these gains is diametrically opposed to the efficient breach theory, the essence of which is that the promisor should be allowed or even encouraged to commit a breach whenever his gains exceed the promisee's loss.

6. *Sellers' incentives to search for an overbidder*. A variant of the argument that resale to overbidders is an important instrument for moving commodities to higher-valued uses is that the right to breach and resell provides an important incentive to sellers to search out overbidders, and this search process should be encouraged because it results in moving commodities to higher-valued uses.[63]

In considering this argument, it must be borne in mind that resales to overbidders will not necessarily result from search by sellers. Consider the following four scenarios in which overbidders may appear on the scene:

I. The seller searches for an overbidder, but an overbidder makes contact with the seller only after the seller has, unbeknown to overbidder, made delivery to the buyer. When the seller

[63] This argument seems to be implicit in the E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1380-82 (1985).

informs the third party that she no longer owns the commodity, the third party purchases the commodity from the buyer. No one argues that in this Scenario the seller has a claim for the buyer's gain on resale.

II. The seller searches out and finds an overbidder before delivery, but the overbidder would have found the buyer in any event. Allowing the seller to keep the gain on resale in this Scenario would make too much depend on an accident of timing. Indeed, in this Scenario the seller has injured the buyer by intercepting a profit that the buyer would certainly have made if the seller had performed.

III. The overbidder searches out and finds the seller before delivery, and will not find the buyer unless the seller provides the third party with the buyer's name. In this Scenario, providing an incentive to the seller to search for an overbidder is unimportant, because the contact between the seller and the overbidder does not result from search by the seller.

IV. The seller searches out and finds the overbidder before delivery, and the third party will not find the buyer unless the seller provides the overbidder with the buyer's name. In this Scenario, if the seller has no incentive to search for an overbidder there may be an efficiency cost. However, it's doubtful that many transactions fall within this Scenario, in part because it's doubtful that many sellers search for overbidders after they have made a sale. Accordingly, the total social loss from disincentivizing sellers from searching for overbidders is likely to be extremely small even if a high proportion of those searches for overbidders that do occur fall within Scenario IV, which is also doubtful. The social loss is made even smaller by the fact that a seller has an incentive to search for an overbidder even if she cannot keep the gain. Having located an overbidder, a seller is under no obligation to disclose the overbidder's identity to the buyer. Accordingly, the seller is free to inform the buyer that she has found an overbidder, and

then either bargain to provide the buyer with the overbidder's name or bargain for the buyer's consent to a sale to the overbidder. If the buyer values the commodity above the overbid price, he will not consent, which is efficient. If the buyer values the commodity below the overbid price, the buyer will negotiate with the seller to divide the gain from the overbid. Accordingly, a seller will have an incentive to seek out an overbidder even if she cannot resell to an overbidder, although admittedly the incentive is somewhat smaller than if she was allowed to retain all the gain from the overbid.

Moreover, standing against the very small possible benefit from providing sellers with the greatest possible incentive to seek out overbidders are the very substantial costs that providing such an incentive would entail. The incentive-for-search argument is simply a variant of the theory of efficient breach, and is therefore subject to all the problems that beset that theory. Given limited information to sellers, and inadequate compensation to buyers, a seller who searches for an overbidder is not searching for a *higher-valuing user*, but only for a *higher-paying third party*. Correspondingly, if the seller locates a higher-paying third party, she will not know whether he is a higher-valuing user. Indeed, he may well be a lower-valuing user. Moreover, if the seller follows up the search for an overbidder by breach and resale, the buyer will not be fully compensated for his losses. Accordingly, searching out an overbidder for the purpose of breach and resale will never be Pareto superior, and there is no reason to believe that normally it will be even Kaldor-Hicks superior.

Allowing sellers to search for overbidders with the objective of unilaterally breaching, rather than negotiating a mutual termination, would have other significant costs. The buyer as well as the seller can search for an overbidder, and the buyer, but usually not the seller, can engage in beneficial reliance to increase the value of the contract. If the seller could rightfully

conduct a search for an overbidder, and then unilaterally breach, the buyer is inefficiently incentivized to reduce his search efforts and his beneficial reliance, because both may be wasted and either uncompensated or not fully compensated.

Finally, encouraging sellers to search for overbidders would entail the other inefficiencies of an efficient-breach regime, such as reducing the efficiency of the contracting system, reducing the incentives for planning and investing, and remaking the parties' contract. It is just this kind of search that *Greer* properly held that a seller implicitly agrees not to engage in.

7. *Summary*. In the context of the Resale Paradigm it cannot be established that the theory of efficient breach would conduce to efficiency. On the contrary, the theory, if widely adopted, would introduce various kinds of inefficiency into the contracting system.

There is one other factor to consider. Suppose it cannot be shown whether an efficient-breach regime or a performance-oriented regime is more efficient. In that event, the only issue is distributional—that is, how to distribute the surplus from an overbid.[64] If efficiency does not provide an answer to that question, morality can be wheeled up. Morally, it is more appealing to award the surplus from an overbid to the party aggrieved by the wrongful breach than to the wrongdoing breacher.

C. The Loss Paradigm

Here are the elements of the Loss Paradigm: (1) A seller has contracted to sell a commodity to a buyer. (2) Before the seller has completed production, she decides that the cost of production will exceed the value that the buyer places on the commodity. (3) The seller breaches rather than performs. (4) The seller pays the buyer damages, which are measured in such a way as to be compensatory under the indifference conception. (5) There is a saving of

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[64] *See* JAMES WHITE & ROBERT SUMMERS, COMMERCIAL LAW 234 (4th edition 2000).

social cost in the amount of the difference between the cost of production and the value that the buyer places on the commodity, minus the costs incurred by the seller prior to breach.

The Loss Paradigm differs from the Resale Paradigm in two critical respects.

First, in the Resale Paradigm the seller breaches to pocket an extra gain. In contrast, in the Loss Paradigm the seller breaches to avoid an unexpected loss. Contracting parties are likely to view a breach to avoid an unexpected loss differently from a breach to reap an extra gain, partly because of the phenomenon of loss-aversion, and partly because breach to reap an extra gain seems opportunistic while breach to avoid an unexpected loss does not. Moreover, because the seller in the Loss Paradigm does not pocket an extra gain, disgorgement is not a realistic remedy, so that the only operational issue raised by the theory of efficient breach in this context is the availability of specific performance.

Second, in the Resale Paradigm there is no persuasive argument that breach will lead to social benefit. In contrast, in the Loss Paradigm there is a persuasive argument that breach will save social costs.

Steven Shavell has made an argument that, if correct, would provide another distinction between the Resale and the Loss Paradigms. In the context of the Resale Paradigm, it is very unlikely that at the time the contract was made the parties would have agreed that the seller would be entitled to resell. In the context of the Loss Paradigm, however, Shavell argues as follows:

> . . . [S]uppose that a contract . . . states only that "The seller will produce a custom desk for the buyer . . . ." [Assume that the buyer values the desk at $1,000.] The buyer and the seller do not really want the desk always to be produced. *It is readily shown that, had they made a complete contract, they would have specified performance if and only if the production cost were less than the $1,000 value of the desk to the buyer*. . . . Now if the . . . contract calling for the desk always to be produced is enforced by the expectation measure of damages . . . , the seller will behave exactly as he would have under the complete

> contract, that is, he will perform if and only if the production cost is less than $1,000. Higher damages than the expectation measure might induce performance when it is inefficient. . . .[65]

It would be easy to read this passage too expansively. Shavell says that if the parties "had made a complete contract they would have specified performance if and only if the production costs were less than the . . . value of the desk to the buyer." Taken in isolation, that sentence could be read to mean that performance would be *excused* if the seller's cost of production exceeded the buyer's value. Clearly, that's not what Shavell means. If performance was excused, no damages would be owing. However, Shavell explicitly contemplates that the seller will pay expectation damages if she does not perform. Presumably, therefore, this passage means that if the parties had addressed the issue, they would have agreed that *specific performance* would not be sought, even if it was otherwise available, if the production cost exceeded the buyer's value.[66] Indeed, this is the only sensible interpretation of this passage. For example, if the cost of production was less than the contract price, a seller would not want a buyer to be excused simply because the buyer's value was less than the cost of production. A seller will also not want a buyer to be excused if, at the time it becomes apparent that the cost of production exceeds the buyer's value, the seller has incurred a significant portion of that cost and would lose more by abandoning the contract than by completing it. Correspondingly, a buyer would not want the seller to be excused simply because the contract became unprofitable for the seller.

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[65] Shavell, *supra* note xxx, at 438-39 (emphasis added). As written, Shavell's hypothetical specifies that the buyer has paid the $1,000 in advance. I have elided that portion of the hypothetical, because if Shavell's reasoning applied only to cases involving advance full payments it would have only a trivial application, which is clearly not Shavell's intent.

[66] Shavell's passage would also exclude supra-compensatory damages. Although it has been forcefully argued that such damages should be awarded, the difficulties in setting the correct level of supra-compensatory damages are inseperable in my view, and I do not consider that alternative in this Article.

With this clarification, it is not the case, as Shavell claims, that it "is readily shown that, had [the parties] made a complete contract, they would have [permitted specific] performance if and only if the production cost were less than the value . . . to the buyer." On the contrary, at the time the contract is made a buyer ordinarily would *not* agree that he would forgo an otherwise-available right to specific performance if the seller's cost of production exceeded the buyer's value. Shavell's claim concerning the Loss Paradigm, like Posner's claim concerning the Resale Paradigm, implicitly depends on flawed predicates concerning compensation and information.

Begin with compensation. A buyer who values a commodity at less than its cost of production may nevertheless incur a loss on breach if he values the commodity at more than the contract price. In the context of the Loss Paradigm, as in the context of the Resale Paradigm, it is a predicate of the theory of efficient breach that expectation damages will make the buyer indifferent between compensation and performance. As shown above, however, expectation damages will not have that effect.[67] As a result, a buyer who values a commodity at less than the seller's cost of production, but more than the contract price, would normally prefer actual or specific performance to breach and compensation.

It is also a predicate of Shavell's claim that the seller will know the value of the contracted-for commodity to the buyer. Otherwise, the seller could not determine whether her cost of production exceeded the buyer's value. However, the seller is no more likely to know the buyer's value in the Loss Paradigm than in the Resale Paradigm.

Furthermore, Shavell critically fails to designate the time at which the parties would agree that the buyer's value should be determined in the Loss Paradigm. Basically, the parties might choose to determine the buyer's value at one of three points of time.

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[67] *See* text at notes xxx-xxx, *supra*.

(i) *The point of time when performance is to be rendered*. This point of time is too late. At that point, the seller is likely to have incurred all her production costs, and therefore will want to enforce the contract even if those costs exceed the value that the buyer places on the commodity.

(ii) *The point of time when the contract is made*. This point of time is too early. If, at the point the contract is made, the parties know that the seller's production cost exceeds the buyer's value, they will not make the contract.

(iii) *The point of time when the seller makes a decision not to perform*. This point of time will be unacceptable to the buyer, because the seller will not know the buyer's value at that point, any more than she will know the buyer's value at the time of the perform-or-breach decision in the Resale Paradigm. Of course, the seller can ask the buyer at that point what his value is, but nothing in the theory of efficient breach—as opposed to the theory of efficient termination—requires her to do so.

In any event, the value that counts is the value the commodity will have to the buyer at the point of time when performance must be rendered. Often a buyer will not know, prior to that point, what value he will set on the commodity at that point. If he is purchasing the commodity for personal consumption, he knows that his preferences may change. If he is purchasing the commodity for resale, he knows that the market price of the commodity may go up or down. If he is purchasing the commodity as an input or factor in production, he knows that the profits to be made from the product that he plans to produce may be higher or lower than he expects.

Shavell's illustration masks the timing problem—and the information problem—in three related ways. First, the illustration finesses the problem, because it fails to specify the time at which the seller will make the decision to not perform. Second, the illustration unrealistically

assumes that the seller's cost of production and the buyer's value will be known to both parties. Third, the desk in the hypothetical is apparently not purchased for resale, and is unlikely to be an important input in, or a factor of, production. Accordingly, it is plausible in the hypothetical—as it would seldom be in a normal commercial context—that the value of the contracted-for commodity to the buyer will stay constant from the time when the contract is made until the time when the seller makes the perform-or-not-perform decision.

In short, the theory of efficient breach ordinarily is not justified in the context of the Loss Paradigm, because neither the compensation nor the information predicates can be sustained in this context. Correspondingly, it is not the case, as Shavell claims, that if a buyer and a seller addressed the issue at the time a contract is made, they would agree that the buyer would not seek specific performance if the seller's cost of production exceeded the buyer's value. The proof of the pudding is in the eating. Contractual provisions often turn on a seller's cost of production—examples are escalator clauses and cost-plus provisions—but contracts rarely if ever make any consequences turn on the relation between the seller's cost of production and the buyer's value. This is not because contracts aren't complete. It is because buyers would not agree to such provisions, for all the reasons given above. In the Loss Paradigm, as in the Resale Paradigm, if a seller concludes that her cost of production will exceed the buyer's value, her appropriate course of action is to request the buyer to agree to a termination of the contract. At least where the parties are in an ongoing relationship, and perhaps even when they are not, it seems likely that most buyers who were asked for a release in this kind of case would be willing

to provide the release on reasonable terms.[68]

There is, however, one class of cases in which the theory of efficient breach, or something like it, could be justified in the context of the Loss Paradigm. These are cases in which it can be concluded with great confidence that the cost of performance is so much higher than the buyer's valuation that the buyer really doesn't want performance, but instead wants (i) either money damages equal to the cost of production, or (ii) a decree of specific performance that he plans to use as a bargaining chip to coerce a windfall settlement at an amount between his value and the seller's costs of production. Not granting specific performance in these cases is justified. If the buyer himself doesn't want performance, then specific performance should not be decreed, and a promisee who seeks specific performance in such cases is himself acting opportunistically.

Cases like this are not thick on the ground, but neither are they unknown. They almost invariably arise in the context of the provision of services. The services may comprise the seller's total performance obligation or may be related to some other performance obligation.

For example, in *Eastern Steamship Lines, Inc. v. United States*,[69] the Government requisitioned Eastern's vessel *Acadia* for use in World War II, and agreed that before it redelivered the *Acadia* it would either restore the vessel to the condition that the vessel was in at delivery, or pay Eastern the amount required to restore the vessel to that condition. The Government did neither, and Eastern brought suit for the projected cost of restoration. The cost

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[68] In a somewhat analogous case, a study of the contract practices of nineteen English engineering manufacturers found that when buyers wished to cancel, typically the sellers would release the buyers in exchange for reimbursement of costs plus a modest profit component. Beale & Dugdale, *Contracts Between Businessmen: Planning and the Use of Contractual Remedies*, 2 BRIT. J.L. & SOC'Y 45, 53(1975). It seems likely that buyers would take a comparable approach to sellers who wished to cancel. *See* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28(1) AM. SOC. REV. 55 (1963). For a discussion of the role of reciprocity in contract modification, see Melvin A. Eisenberg, *The Emergence of Dynamic Contract Law*, 88 CAL. L. REV. 1743, 1762-67 (2000).

[69] 112 F. Supp. 167 (Ct. Cl. 1953)

of restoring the vessel would have been $4 million, but the value of the *Acadia* as restored would have been only $2 million. In these circumstances, it was clear that if Eastern Steamship did not want performance; it wanted $4 million. If that amount was awarded, Eastern would not have used the money to restore the *Acadia*, but instead—assuming that it wanted at least one more vessel—would have either purchased one vessel and put $2 million in the bank, or purchased two vessels. Similarly, if the court ordered the Government to specifically perform, Eastern would not have enforced the decree, but instead would have bargained with the Government to surrender its right to specific performance in exchange for a payment of some amount between $2 million and $4 million.

Similarly, in *Jacob & Youngs, Inc. v. Kent*,[70] Jacob & Youngs contracted to build a country house for Kent. The contract required the use of Reading cast-iron plumbing pipe.[71] After the house had been completed, Kent learned that Jacob & Youngs had installed cast-iron plumbing made by another manufacturer, Cohoes. Cohoes pipe was equal in quality, appearance, market value, and cost to Reading pipe—"indeed, the same thing, though manufactured in another place."[72] Because the pipe was largely encased within the walls of the completed house, installation of Reading pipe in place of the Cohoes would have required a huge expenditure to demolish and reconstruct substantial parts of the house. In these circumstances, it is clear that if Kent had sued for the cost of completion and was awarded that cost, he would not have used the money for that purpose, but instead would have put the money in the bank. Similarly, if a court ordered Jacobs & Youngs to specifically perform, Kent would not have enforced the decree, but instead would have bargained with Jacob & Youngs to surrender its

[70] 230 N.Y. 239, 129 N.E. 889 (1921).
[71] *Id*. at 240, 129 N.E. at 890.
[72] *Id*. at 241, 129 N.E. at 890.

right to specific performance in exchange for a payment of some amount between $1 and the cost of demolition and reconstruction.

To summarize, in the context of the Loss Paradigm the theory of efficient breach might be valid if we lived in a world in which the buyer's compensation and the seller's information concerning the buyer's value were perfect, and there was no difficulty in selecting the point of time at which the seller's cost of production and the buyer's valuation should be determined. However, because the buyer's compensation and the seller's information normally are highly imperfect, and there is grave difficulty in selecting the point of time at which to make the required determinations, the theory normally is not valid in the context of this Paradigm.

Nevertheless, there are occasional cases where the discrepancy between the seller's cost of production and the buyer's valuation is so large, and the buyer's disinterest in performance is so clear, that nonperformance can be condoned on the ground the buyer himself does not want performance. Strictly speaking, even these cases do not raise efficiency issues. If the buyer wants a decree of specific performance only as a bargaining tool to extract part of the cost of performance from the seller, then unless bargaining badly misfires the effect of a decree of specific performance will be redistributional rather than inefficient.

D. The Mitigation Paradigm

Here are the elements of the Mitigation Paradigm: (1) A buyer has contracted to purchase a commodity that the seller will produce. (2) Before the seller has completed production, the buyer decides that the value of the commodity to him will be less than the contract price. (3) The buyer then breaches by countermanding the seller's performance. (4) The buyer pays the seller expectation damages, which are measured in such a way as to be compensatory under the

indifference conception. (5) There is a saving of social cost in the amount of the difference between the contract price and the value that the buyer places on the commodity, minus the costs incurred by the seller prior to the countermand.

The Mitigation Paradigm differs from the Resale Paradigm in three respects. First, the Mitigation Paradigm involves breach by the buyer rather than the seller. Accordingly, breach normally involves nonpayment of money rather than failure to supply a promised commodity. Second, the Mitigation Paradigm involves avoidance of a loss rather than the capture of a gain. Third, in the Mitigation Paradigm performance would involve a social cost, because the buyer values the seller's performance at less than the cost of production.

These three aspects of the Mitigation Paradigm are illustrated by *Rockingham County v. Luten Bridge Company*.[73] Rockingham County and Luten Bridge had entered into a contract under which Luten would construct a bridge for the County. After Luten had begun to construct the bridge, the County decided that it didn't want a bridge, and instructed Luten to stop work. Separately, the County cancelled construction of a road which was to lead to the bridge. Luten disregarded the countermand, completed the bridge, and sued for the price. Because the County didn't want the bridge, and indeed had no possible use for the bridge in the absence of a road, the cost of building the bridge was a social loss, and Luten increased that loss by completing performance.[74]

These differences between the Mitigation Paradigm and the Resale Paradigm (at least one of which—the fact that breach is by the buyer—also differentiates the Mitigation Paradigm from

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[73] 35 F.2d 301 (4th Cir. 1929).

[74] The court properly held that Luten could not recover the contract price. This is the American rule, although the English rule is different. *See* White & Carter (Councils) Ltd. v. McGregor, [1962] A.C. 413; Melvin A. Eisenberg, *The Duty to Rescue in Contract Law*, 71 FORDHAM L. REV. 647, 656-57 (2002).

the Loss Paradigm) lead to very important differences in the application of the evaluative criteria of compensation, information, and efficiency to the Mitigation Paradigm.

Compensation. As shown above, compensation to buyers is highly imperfect. A buyer's losses are usually measured by the difference between market price and contract price, by the buyer's lost profits, or both. The market-price measure often fails to account for the value that a buyer subjectively places on a commodity, and lost profits on potential transactions with third parties are often cut off by the certainty rule, the principle of *Hadley v. Baxendale*, or both.

In contrast, the Mitigation Paradigm involves a breach by a buyer and compensation to a seller. Breach by a buyer normally does not involve the problem of measuring the promisee's subjective valuation because the breach typically consists of the nonpayment of money, rather than the nondelivery of a commodity. Similarly, the nonpayment of money to a seller seldom involves problems under the certainty rule or the principle of *Hadley v. Baxendale*: normally, a seller will not be required to forgo profitable opportunities simply because one of her buyers has not made a payment. Accordingly, the compensation shortfall is likely to be much smaller in the Mitigation Paradigm than in the Resale or Loss Paradigms.

Information. In the Resale Paradigm the seller normally will not have good information about the buyer's loss from breach. Similarly, in the Loss Paradigm the seller normally will not have good information about whether the cost of production exceeds the values that the buyer places on the commodity. In contrast, in the Mitigation Paradigm the buyer will have perfect information about whether the contract price exceeds her valuation, because the contract price is fixed and the buyer has perfect information about her own valuation.

Of course, the buyer doesn't know what profits the seller will lose as a result of a countermand, but normally that is not significant, because the seller's profits are the same

whether the buyer performs or breaches. In cases that fall within the Mitigation Paradigm, the seller's damages are typically measured by (i) the contract price minus (ii) the variable costs remaining to be incurred by the seller at time of breach.[75] Under this formula, if the buyer countermands, the seller recovers its lost profits (including overhead) whether or not it continues to perform. Failure to obey the countermand by continuing to perform therefore drives up the buyer's damages, but not the seller's net recovery.

For example, assume that in *Rockingham County* the contract price was $100,000, the variable costs of building the bridge were $80,000, and the County breached when Luten had incurred $40,000 of those costs. In that case, if Luten stopped work at the time of the County's countermand its damages would have been $60,000—the contract price of $100,000 minus variable costs remaining to be incurred of $40,000. Luten's net recovery, however, would have been $20,000, because of the $60,000 damages, $40,000 would merely reimburse Luten for variable costs incurred prior to breach.

Now suppose that instead of stopping performance, Luten continued to completion, as in fact it did. If that was permissible, Luten's damages would be the contract price, $100,000. There would be no deduction for variable costs remaining to be incurred, because no such costs would remain. However, Luten's net recovery would still be only $20,000, because of the $100,000 damages, $80,000 would merely reimburse Luten for variable costs incurred. Accordingly, Luten's continuation of performance after the County's countermand would increase the County's loss from $60,000 to $100,000 without making Luten better off. By continuing performance after the countermand, therefore, Luten increased the social cost of

[75] Under an equivalent formula, the seller's damages are measured by (i) lost profits (based on the contract price minus total variable costs) plus (ii) variable costs incurred prior to the breach. Both formulas are subject to an offset for amounts previously paid by the buyer, which can be disregarded for present purposes.

building a useless bridge without conferring or deriving any corresponding social or private benefit.

Efficiency. In short, unlike the Resale Paradigm, breach in the Mitigation Paradigm has a clear efficiency justification. Even in this Paradigm, the seller will not be as well off with breach as she will be with performance, because if the buyer performs, the seller will make a profit without incurring dispute-settlement costs, while if the buyer breaches, the seller must incur such costs to recover the amount of its profits. However, requiring mutual consent for termination in such cases would allow sellers to act opportunistically, by using the threat to complete performance as a barga ining tool to appropriate a portion of the difference between the contract price of the commodity and the buyer's valuation. On balance, therefore, efficiency requires that the buyer should be allowed to countermand—breach—in such cases, even though the seller will not be just as well off with breach as with performance.

E. Summary

The analysis is long but the results are simple. The theory of efficient breach is not even plausible in the context of the Resale Paradigm—the Paradigm with which it is most closely associated—because in that context the theory rests on incorrect predicates concerning compensation and information, is highly unlikely to yield efficiency gains, and is highly likely to result in efficiency costs. The theory has a marginally better claim to plausibility in the context of the Loss Paradigm, because under perfect-world conditions of compensation, information, and timing the theory might save social costs, but under real-world conditions the theory is usually unjustified in this context as well. The theory is, however, justified in the occasional Loss Paradigm case in which it is beyond dispute that the promisee does not really want specific performance, but instead only wants a decree that he can opportunistically employ as a

bargaining chip—although even in these cases the real issue not efficiency, but distribution. Finally, the theory is justified in the context of the Mitigation Paradigm.

I will explore the implications of these results in succeeding Parts.