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Deducting Losses Suffered by the Breaching Party from Damages

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D R A F T
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To: Law/Econ Workshop Participants

From: Bob Cooter and Ariel Porat

Re: Paper for workshop on Monday, August 26, 2002.

In 2001 we published a paper in the Journal of Legal Studies that asked a novel question, "If an injury causes the victim to lose 100 and the injurer to lose 40 from social sanctions, should the injurer's liability for damages to the victim equal 100 or 60?" The paper, however, does not explore some special features of the question that arise in contract law. We are in the process of writing, but have not yet completed, a new paper exploring these special features of contract law. Even so, we have substantial results to report that should make for a lively discussion. At my urging, Professor Porat has agreed to briefly review the paper from 2001 and then focus on presenting our new results. (He has completed an entirely different paper that he could present but will not.) The 2001 paper, "Should Courts Deduct Non-Legal Sanctions from Damages," is available here or in hard copy in Simon 793. What follows is the introductory section of the new paper, which we may update on Monday. Please feel free to read any of these materials.

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Deducting Losses Suffered by the Breaching Party from Damages

The party who breaches a contract incurs liability and often suffers additional losses. This paper concerns the desirability of deducting the additional losses from liability. To illustrate, breach of a contract might cause promisee to lose 100 and promisor to lose 40. Should promisor's liability for damages to promisee equal 100 or 60?

The answer varies systematically with the form of the losses suffered by the breaching party. We illustrate three fundamental forms of losses:

Example 1: Lost Profits -- Builder promises to construct a building. Buyer expects to gain 100 from performance and Builder expects to gain 40. Before making expenditures on the project or beginning construction, Builder defaults. Buyer fails to find an alternative Builder and abandons the project. Non-contracting parties are unaffected by the default. Should Builder's liability to Buyer equal 100 or 60?

Example 2: Lost Expenditures—Buyer pays 100 to Builder for promise to construct a building. Buyer expects to gain 100 from performance and Builder expects performance to cost 100. (We make the “zero profit” assumption of perfect competition.) After spending 40 on preparing to perform and partially performing (e.g. making architectural drawing, pouring a concrete foundation, etc.), Builder defaults. Buyer fails to find an alternative builder and abandons the project without receiving any benefit from it. Non-contracting parties are unaffected by the default. Should Builder's liability to Buyer equal 100 or 60?

Example 3: Non-legal sanctions -- Builder promises to construct a building. Buyer expects to gain 100 from performance. Before making expenditures on the project or beginning construction, Builder defaults. Buyer fails to find an alternative Builder and abandons the project. Builder's other potential buyers learn these facts and transfer their business to others, causing Builder to lose 40 and its competitors to gain 40. Should Builder's liability to Buyer equal 100 or 60?

Part I considers incentives for the contracting parties to maximize social value, which equals the sum of the contract's value to everyone affected by it. Promisor has

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incentives to maximize social value when he internalizes the sum of losses that breach causes promisee, promisor, and non-contracting parties. Liability for compensatory damages causes promisor to internalize promisee's losses from breach. No deduction of breaching party's losses causes promisor to internalize his own losses from breach. In the simple case where breach does not significantly affect non-contracting parties, liability for promisee's losses with no deduction for promisor's losses causes promisor to internalize the social costs of breach.

To illustrate by Example 1, liability of 100 will cause Builder to internalize Buyer's costs of breach. No deduction of Builder's loss of 40 will cause Builder to internalize his own costs of breach. By assumption in Example 1, breach does not affect third parties, so liability of 100 with no deduction causes promisor to internalize the social costs of breach.

In some circumstances illustrated by Example 2, however, externalizing some social costs still leaves promisor with sufficient incentives to perform. Before performing on some kinds of contracts, promisor must prepare and partially perform. As promisor prepares and partially performs, the additional expenditures needed to complete performance fall. In general, when performance requires expenditure in stages, the liability required to induce performance falls with the cost of completing performance. To illustrate by Example 2, Builder promises to construct a building at expected cost of 100. After Builder spends 40 preparing and partially performing, completing performance costs 60 more. If Builder contemplates breaching at this point, liability for 60 will induce performance. Deducting breaching party's loss of 40 from compensatory damages of 100 retains sufficient incentives for performance.

When lost profits account for breaching party's losses as in Example 1, or when lost expenditures account for breaching party's losses as in Example 2, substantial effects on non-contracting parties are unlikely or impractical for contract law to comprehend. Lost profits and expenditures are typically "dead weight losses" without offsetting gains to anyone. Incentivizing promisor to avoid these losses, as required to maximize social value, typically requires not deducting the breaching party's lost profits or sunk costs from liability.

Part I next considers situations where breach significantly affects non-contracting parties. When non-legal sanctions cause breaching party's losses as in Example 3, substantial effects on non-contracting parties are likely and contract law can comprehend them. Specifically, non-legal sanctions often transfer business from the breaching party to its competitors. When the breaching party loses business to competitors, the transfer does not change social value. Since social value remains unchanged, the breaching party should not have incentives to prevent the transfer. Removing the incentives to prevent the transfer requires deducting the breaching party's losses from non-legal sanctions. To illustrate by Example 3, Builder's breach apparently causes its competitors to gain 40, so holding Builder liable for 60 will internalize social costs of breach. If Builder were liable for 100 rather than 60, Builder would breach too seldom and deprive his competitors of business.

Having analyzed promisor's incentives in Part I, Part II turns to promisee's incentives. Promisee can often increase a contract's value by assisting performance. To illustrate, Buyer can help Builder obtain construction permits. Conversely, promisee can often reduce the contract's value by over-relying. To illustrate, Buyer who contracts with mover to move into a building on its promised date of completion increases losses from tardy construction. To create incentives for promisee to assist and rely at socially efficient levels, promisee should internalize the social costs of breach. Receiving no damages for breach causes promisee to internalize her own losses. Consequently, starting from any positive level, reducing damages almost always improves promisee's incentives.

To illustrate by Example 1, damages of 100 cause promisee to externalize her losses from breach. Reducing damages from 100 to 60, whether by deducting breaching party's losses or for any other reason, improves promisee's incentives by causing her to internalize 40% of her losses from breach. Reducing damages from 100 to 0 causes her to internalize 100% of her losses from breach.

Promisor and promisee have incentives to maximize social value when each of them internalizes the sum of losses that breach causes promisee, promisor, and non-contracting parties. Deduction increases social value because promisor's incentives remain sufficient by assumption and promisee's incentives necessarily improve.

To illustrate by Examples 2, any deduction from damages of 100 improves Buyer's incentives. Furthermore, a deduction of up to 40 retains sufficient incentives for Builder's performance.

Combining results on promisor and promisee, we conclude that ideal incentives to maximize social value typically require promisee's damages to differ from promisor's liability. By current law and contract practices, promisor's liability typically equals promisee's damages. (Elsewhere we explain how to achieve ideal incentives for both parties by using a novel contract called "anti-insurance.") Given the constraint that liability equals damages, a tradeoff exists between incentives of promisor and promisee. The tradeoff differs according to the character of the breaching party's losses.

In Example 1 where the breaching party suffers lost profits, promisee's ideal damages equal zero and promisor's ideal liability equals promisee's losses. Starting from 0, any increase in damages and liability up to 100 improves promisor's incentives and worsens promisee's incentives. Above 100, any increase in damages and liability worsens the incentives of both parties. The socially efficient deduction could be anywhere between 0 and 100.

In Example 2 where the breaching party suffers lost expenditures, promisee's ideal damages equal zero and promisor's ideal liability equals 60. Starting from 0, any increase in damages and liability up to 60 improves promisor's incentives and worsens promisee's incentives. Above 60, any increase in damages and liability worsens the incentives of both parties. The socially efficient deduction is at least 60. Generalizing, social efficiency requires deducting the breaching party's lost expenditures from liability when the parties consider that the costs of completing performance are very unlikely to exceed the promisor's losses. .

In Example 3 where the breaching party suffers lost business and his competitor's gain an equal amount of business, promisee's ideal damages equal zero and promisor's ideal liability equals 60. Starting from 0, any increase in damages and liability up to 60 improves promisor's incentives and worsens promisee's incentives. Above 60, any increase in damages and liability worsens the incentives of both parties. The socially efficient deduction is at least 60. In general, deducting breaching party's losses that transfer as gains to third parties improves the incentives of both contracting parties. Later

we explain that non-legal sanctions for breach typically cause significant third party benefits that contract law can practically deduct, whereas lost profits and expenditures typically cause insignificant third party effects that contract law cannot comprehend.

Parts I and II concern maximizing social value, which provides a useful normative guide to lawmakers. Part III considers breaching party's losses from the perspective of maximizing the contract's private value to its parties, which we call "contractual value." Whereas social value encompasses effects on contracting and non-contracting parties, contractual value only encompasses effects on contracting parties. Since self-interest motivates the parties to maximize contractual value, so analysis from this perspective provides useful predictions.

Significant effects of breach on non-contracting parties cause a conflict between social and private goals. Breach affects non-contracting parties in Example 3 on non-legal sanctions, but not in Example 1 on lost profits or Example 2 on lost expenditures. We have explained that maximizing social value requires deducting from liability the breaching party's losses caused by customers transferring their business to others. This conclusion does not apply to contractual value. Breaching parties losses reduce contractual value by the same amount regardless of whether the loss is deadweight or transferred. To maximize the contract's value to its parties, the breaching party should internalize its losses, regardless of whether or not they transfer value to non-contracting parties. To illustrate by Example 3, maximizing social value requires liability to equal 60, and maximizing contractual value requires liability to equal 100.

Should lawmakers enact a rule requiring a deduction from liability of breaching party's losses from non-legal sanctions? Lawmakers could enact a default rule or a mandatory rule. First consider a default rule, whose obligations the parties can change by agreement. The lawmaker who aims to maximize social value should typically supply defaults rule that most contracting parties prefer. If the law adopts a default rule and the parties contract around it, the rule merely increases transaction costs in most circumstances.³ Consequently, default rules that fail to supply the terms desired by most contracting parties usually fail to maximize social value. Lawmakers who wish to

³ Forcing the parties to contract around a default rule can sometimes makes them reveal useful information. See Ayres and Girtner...

maximize social value should not create a default rule requiring a deduction of the breaching party's losses from liability. Second, consider a mandatory rule requiring deduction from liability of breaching party's losses from social sanctions. The parties cannot contract around a mandatory rule, but they can avoid it by changing their behavior to fall outside its scope. Evaluating mandatory rules requires considering whether or not the improvement in behavior conforming to the rule increases social value more than the loss from avoiding the rule.

So far the paper has implicitly assumed that the contracting parties cannot influence whether or not the breaching party suffers a non-legal sanction. [For the breaching party to suffer non-legal sanctions, the breach must be known by people other than the parties to the contract. Filing a suit and proceeding to trial typically triggers non-legal sanctions. Thus the parties to a contract can avoid social sanctions by secrecy, especially through a settlement or private arbitration. Parties who foresee significant social sanctions from publicizing a breach write contracts that secure secrecy by mandating arbitration. A mandatory rule requiring deduction of breaching party's losses from social sanctions would cause parties to settle or arbitrate in circumstances where they would not otherwise do so. This fact illustrates social losses from avoiding the mandatory rule requiring deductions. If this distortion were small, then a rule mandating deduction of breaching party's losses from social sanctions would increase social value.