

The Myth of Efficient Breach

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Abstract

We defend contract law's preference for the expectation remedy against economic, doctrinal, and moral critics, who argue that a promisee should have a right to specific performance. It follows from this claim of right that the expectation remedy unjustifiably favors promisors, by allowing a promisor to capture the entire gain from unilaterally exiting a contract as long as she compensates her promisee for whatever profit he would have realized had he received the goods or services the contract described.

We show, however, that a promisee's gross payoff under the typical contract is invariant to the remedy the law accords him, but that his net payoff, for transaction cost reasons, is higher under a contract that protects his expectation. This showing supports the *dual performance hypothesis*, which holds that the promisee typically gives his promisor discretion either to trade the goods or services at issue or to make a transfer to the promisee in lieu of trade. A promisor who transfers rather than trades therefore does not breach; rather, she breaches only when she rejects *both* trade and transfer. Moreover, a promisee's suit to recover his expectation is a specific performance action to enforce the contract's transfer term. We further explain that this approach renders contract law coherent; is consistent with the law's immanent normativity; and is consistent also with the morality of promising.

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1. Introduction

A contract is typically constituted by an exchange of promises. This paper responds to a growing chorus of claims that the standard remedy for breach of contract – the expectation remedy – is unjust.¹ These claims originated in the Academy but are beginning to make headway among courts and other lawmakers. The recent draft of the Restatement of Restitution gives courts discretion to replace the expectation remedy with disgorgement damages when justice so requires², and such “gain based damages” are beginning to be awarded in England and Israel.³ American courts also increasingly exhibit distaste for restricting contract damages to the promisee’s loss when the promisor benefitted from breach.⁴

¹Part IV below reviews in detail the arguments that are advanced to support this claim. These arguments are briefly summarized here.

²The disgorgement remedy requires the promisor to transfer her gain from breach to the promisee. The proposed Restatement (Third) of Restitution and Unjust Enrichment (Tentative Draft No. 4) (2005), in §39, permits courts to order disgorgement when justice so requires and when the expectation remedy is inadequate. A thoughtful analysis, by the drafter, is Andrew Kull, “Disgorgement for Breach, the ‘Restitution Interest’, and the Restatement of Contracts”, 79 Texas L. Rev. 2021 (2001).

³ For England, see Ralph Cunnington, “The Assessment of Gain-Based Damages for Breach of Contract”, 71 The Modern Law Review 559 (2008). For Israel, see *Adras Building Material Ltd v. Harlow & Jones GmbH*, 3 Restitution L. Rev. 235 (1995).

⁴ Traditionally, disgorgement remedies were awarded only in narrow classes of cases. For example, disgorgement might be awarded in cases in which the breaching party violated a fiduciary or quasi-fiduciary duty owed to the victim of the breach. See, e.g., *Snepp v. United States*, 444 U.S. 507 (1980) (awarding the CIA disgorgement of profits earned by a former agent in connection with a tell-all book published without being vetted as required by his contract of employment with the CIA); *Ajaxo, Inc. v. E*Trade Group, Inc.*,

The case against the expectation remedy rests two grounds. First, the remedy divides the gains from contract unfairly. Second, the remedy is inconsistent with the immanent normative structure of contract law – the norms that this body of doctrine instantiate – and is also inconsistent with the ordinary morality of promising. This paper attempts to refute both criticisms. The expectation remedy, we argue, divides contractual surplus as parties prefer; and the style of surplus sharing associated with the expectation remedy comports with both the internal normative logic of contract law and the morality of promising.

135 Cal. App. 4th 56-57, 37 Cal. Rptr. 3d 221 (2005) (awarding a disgorgement remedy in connection with breach of a nondisclosure agreement governing trade secrets or proprietary confidential information); X-It Prods., L.L.C. v. Waler Kidde Portable Equip., Inc., 155 F. Supp 2d ____ (2001) (observing that “equitable remedies” including disgorgement, may be awarded in cases of “wrongfully obtained profits in a variety of contexts, including breach of fiduciary obligation or breach of contract” but suggesting that the proper award of these remedies depends on a factual finding of “unclean hands”). Another narrow class of cases in which disgorgement remedies have historically been awarded concerns breaches of contract to sell land, where courts, when they are unable to adopt the traditional specific performance remedy for technical reasons, have imposed constructive trusts on breaching sellers and required them to disgorge their gains from breach. See, e.g., *Gassner v. Lockett*, 101 So. 2d 33 (Fla. 1958) (imposing a constructive trust against a breaching seller where a new buyer’s recording of title prevented the court from ordering specific performance of the sale to the buyer against whom the seller breached).

Recently, there has been a trend towards looking more favorably on disgorgement remedies in connection with ordinary breaches of contract. See *EarthInfo, Inc. v. Hydrosphere Resource Consultants, Inc.*, 900 P.2d 113, 119 (Colo. 1995) (approving restitution for breach of contract where a defendant’s wrongdoing leads directly to her profits); *Univ. of Colo. Found., Inc., v. Am. Cyanamid Co.*, 342 F.3d 1298 (Fed. Cir. 2003) (recognizing *EarthInfo* as stating Colorado law); *Daily v. Gusto Records*, 2000 U.S. Dis. LEXIS 22537 (M.D. Tenn., Mar. 31 2000) (endorsing the *EarthInfo* logic); *Dastgheib v. Genentech, Inc.*, 483 F. Supp. 2d 546, 552 (E.D. Pa. 2006) (approving of disgorgement in *EarthInfo* type situations).

It is helpful to begin by clarifying what is at stake in the argument between critics and supporters of the dominant doctrine. Parties contract in order to realize gains from trade. A seller expects to realize the contract price less her cost of performance, and a buyer expects to realize the value he attaches to performance less the contract price. The current legal remedy serves an insurance function. To see this, observe that the buyer (whom we shall, for expositional convenience only, treat as the promisee) realizes his value less the price when the parties trade. The buyer also realizes his value less the price when the seller rejects trade because the buyer may sue for the gain that trade would have created.⁵ In common parlance, thus to insure the buyer is to protect his expectation interest.

Critics of current law argue that a contract does not make the promisee the beneficiary of an insurance policy but rather grants the promisee a right to the promisor's performance. It follows from this view that the legal and moral structure of contractual obligation requires contractual promises to be specifically performed. This, the critics say, is because a contract law that permits an agent to bind herself to perform *and* that permits the agent to breach if she pays a legally set price is incoherent. A law of contract must permit agents to bind themselves. Hence, the law is made coherent only if it protects the promisee's property right in the promisor's performance.

The distinction between a remedy that insures the promisee and a remedy that protects his property right has practical significance when trade would be inefficient. A trade is inefficient,

⁵It is helpful to distinguish "contract" from "trade". Parties contract when they agree to sell goods for a price. Parties trade when the seller delivers the goods and the buyer pays.

in turn, when the promisor's cost of trading exceeds the promisee's value from trade.⁶ *Not trading* thus creates a "gain": the cost the promisor avoids by rejecting trade less the lower value the promisee foregoes. Both critics and supporters of current law accept the law's insurance function: it is agreed, that is, that a promisee should be permitted to recover the difference between his value and the price when the promisor rejects trade. The remedies for which the critics argue, however, would also permit the promisee to recover the difference between the seller's cost and the price. When the seller's cost exceeds the buyer's value – i.e., when trade is inefficient – the promisee would have a higher payoff under a property right remedy than he has today under the expectation remedy.

It is more common to characterize the argument as a choice between remedies, not between payoffs. Supporters of current law thus claim that the promisee is entitled only to expectation damages while critics claim that he is entitled to specific relief. We focus here on payoffs because when trade is inefficient the promisor would exit on payment of a monetary transfer under a specific performance regime just as she now exits under the current expectation based regime. To see how, realize that the promisor can deprive the promisee of the full "nontrading" gain by trading.⁷ In a specific performance based regime, both parties thus have

⁶When trade is efficient, the Coase Theorem teaches that parties bargain to trade independently of the legal remedy. The promisor's trading cost either is an opportunity cost or a historic cost. When a third party bids for goods the promisor agreed to sell to the promisee, the opportunity cost of trade is the third party bid that the promisor rejects. When there is no third party, the (historical) cost of trade is the production expense the promisor would incur to produce and deliver the goods.

⁷The nontrading gain is either a gain, in the conventional sense of the term, or the avoidance of a loss. Regarding an actual gain, if a third party values the promisor's performance more than the promisee does, the promisor can increase her profit by trading with the third party. Regarding a loss, when the cost of

bargaining power: the promisor must pay a portion of the nontrading gain in order to exit but the promisee must yield a portion of the nontrading gain in order to avoid performance. As a consequence, a promisee with a right to performance would share the nontrading gain with his promisor in a renegotiation. In contrast, the promisor today also exits the contract upon making a monetary transfer, but she does not need the promisee's consent: the promisor must pay to the promisee only the gain the promisee would have made from trade. The promisee apparently lacks the bargaining power to extract a portion of the gain that not trading creates. The critics' position thus comes to this: in theory, a contract law that recognizes the promisee's right to specific performance achieves coherence; in practice, a contract law that recognizes the promisee's right to specific performance increases the promisee's payoff.

Economic contract theorists – who deny that these observations underwrite an objection to the expectation remedy – accept the characterization of contract law that leads critics to be critical – namely that the law permits, and indeed encourages, promisors to capture the full gain from not trading. On the economic view, a promisor should reject trade when the cost of trading would exceed its value to the promisee. Contract law causes this condition to be satisfied by requiring the promisor to pay (only) the promisee's foregone value. This has been sufficient in the law and economics literature. Scholars there care more about the size of the pie than either the structure of the doctrine or how the pie is divided up, and so they have not been troubled by thoughts that the expectation remedy may undermine the structure of contractual obligation or

selling goods to the promisee would exceed the promisee's value, not trading avoids a loss, which would be the difference between the avoided trading cost and that value. A promisee with a property right – i.e., a right to specific performance – could extract a portion of an actual gain or require the promisor to pay him a portion of an avoided actual loss.

favor promisors over promisees.⁸

Both champions and critics of the expectation remedy are united, therefore, in their rejection of what we call “the dual performance hypothesis”. On both types of contract theory, the promisor, in effect, makes a simple promise: to trade goods or services in return for a price. The failure to deliver, in both theories, thus is a “breach”. The theories disagree normatively. According to the champions, who tend to be economists, it is enough that the law protects the promisee’s trading gain because this degree of protection causes the promisor to reject trade just when trade would be inefficient. According to the critics, who tend to be moralists or philosophers but who now include judges and restatement drafters, restricting the promisee to his trading gain violates his rights because he also is entitled to the nontrading gain.

The dual performance hypothesis, by contrast, holds that the typical promisor makes a promise in the alternative: to deliver goods or services in return for a price *or* to make a monetary transfer to the promisee in place of delivery. On this view, the promisor “breaches” only when she fails to comply with either aspect of her promise: that is, she fails to deliver *and* she refuses to pay. Put another way, a promisee does have a right but it is either to the delivery of the promised goods or services *or* to the delivery of the promised money, at the promisor’s

⁸The general law and economics view is captured in the title of a recent article: Richard A. Posner, “Never Blame the Contract Breaker”, __ Michigan L. Rev. __ (2009). Louis Kaplow and Steven Shavell are an important exception to this consensus. They argue that much of contract law is distributionally fair because parties would contract for many of the rules we have. See Louis Kaplow and Steven Shavell, *Fairness Versus Welfare* 172-96 (2002). On the other hand, these theorists also characterize the promisor’s failure to trade as a breach. We extend and clarify their views below.

discretion. The failure to deliver the goods or services simpliciter thus is not a breach.⁹

Contract theorists of both an economic and a philosophical bent commonly either ignore the dual performance hypothesis altogether or reject it as being at least psychologically and

⁹We attempt to advance Richard Craswell's insight regarding expectation damages that "the equivalent of the promised performance itself depends on the full and exact scope of what was promised *including the exact scope of what was promised in the event of a breach.*" Richard Craswell, "Expectation Damages and Contract Theory Revisited", Stanford Law and Economics Working Paper No. 325 (2006) at 12 (emphasis in original). See also *id.* 20-21, and Richard Craswell, "Contract Law, Default Rules and the Philosophy of Promising", 88 Mich. L. Rev. (1989). We would substitute a phrase such as "the failure to tender the goods" for "breach". Our claim then is that the promisee receives "the equivalent of the promised performance" when the promisor makes a monetary transfer that equals the promisee's gain from trade. This transfer is "the exact scope of what was promised in the event" that the promisor does not tender. We note, moreover, that this conceptual recharacterization of the expectation remedy, which is developed in greater detail in Part 4 below, also answers Craswell's famous challenge that philosophical arguments have been unable to explain "those parts of contract law that govern the proper remedies for breach." See *id.* at 489, 517-521.

Our view is beginning to be recognized in the economics literature. Bentley MacLeod defines a "warranty contract" as what we later call the "standard contract": the buyer agrees to pay the price for a good that conforms to the contract and the seller agrees to make a transfer if the good does not conform. MacLeod remarks: "Observe that, under a warranty contract, the production of a defective good *does not* result in a breach of contract. Only if the seller refuses to compensate the buyer is there a breach." W. Bentley MacLeod, "Reputations, Relationships, and Contract Enforcement", XLV J. Econ. Literature 595, 602 (2007). See also Philippe Aghion and Benjamin Hermalin, "Legal Restrictions on Private Contracts Can Enhance Efficiency", 6 J. L. Econ. & Org. 381, 401 (1990).

perhaps also ethically implausible.¹⁰ A promisee, it is said, intends to contract for goods or

¹⁰As an example of not considering the possibility that the promisor may have made two promises, see:

“Suppose ... that I have promised to sell you my house that I could get more money by breaking my promise and selling that house to someone else is not a sufficient reason to do that. . . . At a more fundamental level, ... what *made* my action wrong was not that I acted for a bad (selfish) reason, but rather the fact that I had promised to sell you the house. ... What makes it wrong to sell to the second potential buyer is that I promised to sell to the first one.” Thomas Scanlon, *Moral Dimensions* 23-24 (2008). Scholars who acknowledge the hypothesis have been rejecting it for a long time. Frederick Pollock wrote, in 1891, that

“A man who bespeaks a coat of his tailor will scarcely be persuaded that he is only betting with the tailor that such a coat will not be made and delivered to him within a certain time. What he wants and means to have is the coat, not an insurance against not having the coat.”

Frederick Pollock, *Principles of Contract* xix (London, Stevens & Sons rev. 3d ed. 1881). For a modern view, see, among others, Stephen Smith, who claims that “[i]t just seems implausible, as a matter of fact, to regard contracting parties as having agreed, in the typical case, to disjunctive obligations to perform or compensate.” Stephen A. Smith, *Contract Theory* 402 (2004). Similarly, Andrew Gold claims that “as a general description of what parties intend, or even as an interpretation of the public meaning of contract language, [the dual performance hypothesis] seems inadequate.” Andrew S. Gold, “A Property Theory of Contract”, 103 *Northwestern Univ. L. Rev.* 1, 54 (2009). Commentators sympathetic to the hypothesis either assert it without development or raise the hypothesis only as a formal possibility. Jody Kraus thus observes: “... the efficient breach hypothesis *presumes* that many parties use the remedial default rules of contract to specify a morally acceptable alternative to performance of their promised act instead of writing an explicit alternative promise contract.” Jody S. Kraus, “The Correspondence of Contract and Promise”, 109 *Colum. L. Rev.* 1603, 1638 (2009) (emphasis added; footnote omitted). As evidence of Kraus’s observation, Alan Schwartz and Robert Scott assert: “[w]hat contract performance requires is the goods in

services; he does not intend to sell an option that permits the promisor either to trade or to pay. We agree that the primary function of a procurement contract is procurement, but we nevertheless argue here that the dual performance hypothesis is well grounded.

Our argument in favor of the dual performance hypothesis proceeds along two intertwined paths. One path, which is developed in Parts 2 and 3, sets out a simple model that exhibits the efficiency and distributional properties of the contracts that feature in much of the law and economics and about all of the philosophical literature. The model produces three results.

First, it recreates the standard result that current contract law is an acceptable default for typical parties. The legal transfer term – i.e., the value of the promisee’s expectation – induces trade when and only when trade is efficient. This maximizes the expected contractual surplus for parties to share.

Second, the model shows that promisees share in *both* the trading gain and the nontrading gain under current contract law. To see how, recall that the trading gain – the promisee’s expectation – is the difference between the value the promisee would realize from trade and the price. A promisee with a right to specific performance can capture both this trading gain and a

exchange for the contract price *or* the payment of an appropriate monetary substitute. Thus, the damage remedy is itself a part of the contracted-for performance.” Alan Schwartz and Robert E. Scott, *Sales Law and the Contracting Process* 389 (2nd Ed. 1991). Randy Barnett raised the dual performance hypothesis as a possibility in his effort to render the positive law governing personal services contracts consistent with his proposal for “a remedies rule which generally favors specific performance”. See Randy Barnett, *Contract Remedies and Inalienable Rights*, in *Philosophy & Law* 179, 197 (Jules Coleman & Ellen Frankel Paul eds., 1987). We attempt to advance the argument by *showing* that parties would write dual performance contracts in the conditions most analysts suppose.

portion of the nontrading gain: the promisor must pay him this share as a bribe to exit. As a consequence, the promisor's cost of rejecting trade is the sum of the promisee's trading gain and the bribe. Since prices include costs, the contract price reflects both cost types. Now withdraw the promisee's right to specific performance. Competition will then cause the price to fall by the magnitude of the bribe the promisor no longer has to pay. Holding the promisee's value fixed, the promisee's damages increase as the price falls. And since the reduction in price equals the expected bribe, expectation damages permit the promisee to share in the nontrading gain. The choice between current law and its critics therefore reduces to the question whether promisees have second order reasons for preferring to share in the nontrading gain through the price mechanism – i.e., through expectation damages – or to share in that gain through the renegotiation mechanism – i.e., through the specific performance induced bribe.

Our third result, implicit in the second, is to show that parties to contracts that do not explicitly address remedies nevertheless take remedies into account. This is because parties take prices into account and the price is partly a function of the remedy. As just explained, a buyer with a right to specific performance pays a higher price than a buyer without that right, a result that sophisticated parties understand.

We go on to argue that promisees do have second order reasons to realize gains through lower prices rather than through property right induced bribes. As examples of these reasons, though the buyer's expected gross payoff is the same under the standard contract and the property right contract, the cost of creating a property right contract, we show below, exceeds the cost of creating the standard contract. Buyer/promisees thus have higher net payoffs under the standard contract. Further, when the seller rejects trade, the parties play a zero sum bargaining game. Every dollar the seller pays to the buyer is a dollar that the seller loses. The seller's

incentive to resist payment is increasing in the size of the payment the buyer seeks. Since the buyer has a higher ex post payoff under the property right contract, the seller bargains harder, and perhaps less ethically, to pay him under that contract than she bargains when the buyer is seeking only his expectation. Reasoning such as this implies that price sharing – i.e., current law -- would be a good default were property right contracts enforceable; parties then could be taken to accept contracts that restrict the promisee to his expectation unless a contract gives the promisee a right to performance.¹¹ That parties can hold this preference vindicates the dual performance hypothesis.

The other path along which our argument travels, which is developed in Part 4, seeks to connect the structure of surplus sharing that our model identifies to the normative structure of

¹¹In most jurisdictions, current law is mandatory: courts do not enforce contracts for specific performance. See Edward Yorio, *CONTRACT ENFORCEMENT: Specific Performance and Injunctions* 439-448 (1989), Supplemented in Steve Thel, 2009 Cumulative Supplement 233-241. The proposed new UCC Article 2, in §2-716(1), recommends that courts should enforce specific performance terms in commercial contracts but no states have adopted this Article, and it is about to be withdrawn. A recent paper makes two claims regarding the disgorgement remedy: (a) it is awarded frequently; and (b) it is an efficient remedy when courts cannot fully protect the promisee's expectation. See Steve Thel and Peter Seigelman, "The Role of Disgorgement in Contract Law", Manuscript (2008). The first claim appears to reflect a recharacterization of the expectation remedy. Thus, market damages – the difference between the contract price and the ex post market price – are thought to protect the expectation. A promisor who sells to a third party at the ex post market price must pay market damages to the promisee. Since these damages equal her gain, Thel and Siegelman classify market damages as a disgorgement remedy. We use the more common classification of these damages here. We do not take up their second claim because our goal is to justify the expectation remedy when it does what it is meant to do. We argue below that parties should be permitted to contract for specific performance or disgorgement, but that these should not be the default remedies.

contractual obligation and the principles of promissory morality that contract law implicates.

Here again our argument involves three claims.

Fourth, we argue that the dual performance hypothesis is consistent with the normative structure of contractual obligation. Regarding theory, the dual performance hypothesis restores coherence to contract law. Contract law must permit parties to make binding promises. A law that restricts the promisee to the payment of a preset monetary sum is coherent if the promisor binds herself *either* to deliver goods or services or to pay that preset sum. Moreover, a promisee without a right to the promisor's performance has the same expected payoff, or a higher payoff, than the promisee with that right. Thus, current contract law is as distributionally just as the law that the critics favor. We therefore reject the familiar suggestions that the expectation remedy merely prices rather than sanctions breach and that contract law betrays its own normative commitments when it encourages promisor exit.

Fifth, the type of sharing associated with the dual performance hypothesis is morally appropriate for promisors and promisees who interact, as they do in contract, at arm's length. In making this argument, we take on the core moral objection to the dual performance hypothesis, which is (roughly) that the expectation remedy encourages promisors to behave, within the promise relation, in a self-interested way that betrays the solidarity that this relation should properly involve. We argue, to the contrary, that the thinner form of promissory solidarity associated with the dual performance hypothesis, in which the terms of contractual sharing are cabined by the parties' contract, is appropriate for commercial transactions in open, cosmopolitan economies.

These claims, like the claims elaborated along our argument's first path, are principally formal or analytic. We develop a representation result. This result exhibits the surplus-sharing

associated with contract doctrine's preference for the expectation remedy and elaborates the meaning of that sharing so as to render it consistent with the solidarity that contractual and promissory norms more generally require. These results thus answer the current criticisms of the expectation remedy because the criticisms themselves are largely formal and analytic.

But we believe that a further, substantive claim might also be made in favor of the dual performance hypothesis, namely that this hypothesis best interprets, and indeed rationalizes, the current state of the positive law, including both case-outcomes and the doctrines under which those outcomes are reached.¹² We introduce, but do not elaborate, this sixth claim in our conclusion. The suggestion that our thesis conforms to the positive law should not surprise: we are defending the conventional view that the expectation remedy should be the law's principal response to breach of contract. Our account is not entirely conventional, however. We show that a promisor who voluntarily pays expectation damages is best understood, by analogy to one who makes a transfer under a liquidated damages clause, as performing the contract rather than breaching it. We also show that the expectation remedy is a special case of specific performance.¹³ According to our view, then, expectation damages, as conventionally

¹²A thoughtful discussion of how explanations of outcomes and doctrines may differ is in Jody S. Kraus, "From Langdell to Law and Economics: Two Conceptions of Stare Decisis in Contract Law and Theory", 94 *Va. L. Rev.* 157 (2008).

¹³A seller's action for the price is commonly viewed as an action specifically to enforce the contract's price term. Thus, Comment 7 to UCC §2-709 recites: "If the action for the price fails, the seller may nevertheless have proved a case entitling him to damages for non-acceptance." Similarly, a buyer's suit for expectation damages, on our account, is a suit specifically to enforce the contract's transfer term. The difference between these cases is that the seller is suing to recover a number that the contract specifies – the price –

understood, are epiphenomenal. This, of course, is not the conventional account of the positive law of contract remedies. We suggest, although we do not fully argue the point here, that it is nevertheless implicit in the best reconstruction of the doctrine.

We conclude this Introduction with two caveats and a methodological observation. First, the analysis below applies to commercial transactions. Our paradigm case is an agreement to produce a widget, not an agreement to cook dinner together on Thursday nights. This focus has two consequences. First, it permits us to abstract from the familial and affective claims to which contracts in private circumstances may give rise. It would be a category mistake, for example, to offer \$50 to a friend when circumstances caused you to cancel a dinner date with him. It is not a category mistake for the promisors in our analysis to offer money to promisees when the promisors fail to deliver goods.¹⁴

while the buyer is suing to apply a formula that the contract specifies – value less price. This distinction is without normative significance.

¹⁴Recent experimental papers elicit the opinions of individual subjects regarding the theory of efficient breach. A common response is that subjects, cast as promisors, would pay more than the promisee's expectation interest when they refuse to perform. This is taken to exhibit the subjects' view that breaching on payment only of expectation damages is immoral. See, e.g., Tess Wilkinson-Ryan, "Do Liquidated Damages Encourage Efficient Breach?", Manuscript (2008). These experiments are not relevant to our project for two reasons. First, the subjects are individual persons, not firms. A firm is more likely to exhibit behavior consistent with the maximization of monetary returns than an individual responding to a questionnaire. Second, and of greater significance, the subjects were told that nonperformance was a breach of contract. A typical question thus asks whether the subject should "break the contract with the Millers [the promisees] and fully compensate the Millers for their loss" if the subject had a better opportunity. Wilkinson-Ryan at 4. The issue we pursue is whether the promisee would "break the contract" if she failed to deliver but made the transfer that the contract requires. Experimental subjects were not asked this

The second consequence of analyzing commercial transactions is that this permits us plausibly to assume that parties are competent to make contracts and to renegotiate them when circumstances change. We make this assumption not only for its realism but also for heuristic reasons. Current critiques of contract law implicitly assume full rationality. They do not claim that the law constitutes a trap for the weak-minded, but rather that a rational promisor can use the law to deprive her rational promisee of the full nontrading gain. We analyze this core contracting case to show that the concern is misplaced.

Our second caveat is that we take the problem largely as prior commentators have posed it. Analyses of the expectation interest commonly assume, or more commonly presuppose, that (a) parties know the values of the relevant economic parameters; (b) parties know the law; and (c) a court can recover enough information to protect the promisee's expectation. We also make these assumptions – i.e., we accept the problem as previously set out – because life is sometimes like that and, again, for heuristic purposes. Our goal is to refute the claim that contract law is unjust even in ideal circumstances. Put more vividly, on the assumptions that govern the current debate, no breach is efficient.

question. See also Tess-Wilkinson-Ryan and Jonathan Baron, “Moral Judgment and Moral Heuristics In Breach of Contract”, 6 *J. Empirical Studies* 405 (2009) (persons assess the morality of breach partly on the basis of the promisor's intentions); David Baumer and Patricia Narschall, “Willful Breach of Contract for the Sale of Goods: Can the Bane of Business be an Economic Bonanza”, 65 *Temple L. Rev.* 159 (1992) (Subjects given a questionnaire were told that a “breach” was “deliberate” and “willful”). A recent experimental study suggests that “people have a preference for keeping promises per se.” A promise, that is, “creates a contractual *obligation* to the person to whom it is made.” See Christoph Vanberg, “Why Do People Keep Their Promises? An Experimental Test of Two Explanations”, 76 *Econometrica* 1467, 1468, 1476 (2008). The question we ask, again, is just what, in commercial contracts, that “obligation” consists in.

Finally, our formal model and our more discursive analysis are each constructed with the other in mind (this is why we say that the two paths of our argument are intertwined). The model's account of the structure of contractual sharing is developed to answer conceptual concerns about the relationship between contract remedies and contractual solidarity. And our interpretive engagement with the doctrinal, normative, and moral structure of contract aims to elaborate this structure in light of the instrumental interactions between contracting parties that our model highlights. We return to comment on this marriage between economics and philosophy in our conclusion.

Part 2 sets out a model of the parties' contracting problem, which Part 3 then solves. Part 4 interprets the results to show how they clarify the normative issues that occupy the literature and that are beginning to affect the law. Part 5 is a conclusion.

2. A Model of Contracting

2.1 An example

We introduce the model with an example that exhibits the intuition behind it. Assume that (a) a contract that offers the buyer a right to specific performance is enforceable; (b) parties share any contractual surplus equally (the seller, that is, has equal bargaining power with any buyer)¹⁵; (c) the market has several sellers. In the example, the product costs the seller 6 to produce. The associated "property right price" for the product is 8. The seller makes a contract at the price of 8 with an initial buyer, who values the product at 10. This buyer's expectation is value less price: $10 - 8 = 2$. In the interim between making the contract and the performance date, a second buyer approaches the seller to bid 12; this buyer's valuation for the product is 14.

¹⁵The equal bargaining power assumption is without loss of generality. Our later results hold for any division of bargaining power.

Social welfare from performing either contract is the buyer's value less the seller's cost (we assume no externalities). Hence, the social gain from performing the initial contract is $W_1 = v_1 - c = 10 - 6 = 4$. Similarly, $W_2 = v_2 - c = 14 - 6 = 8$. The marginal social gain from selling the product to the second buyer rather than the first is $W_2 - W_1 = 8 - 4 = 4$. The second buyer's bid of 12 thus shares this marginal surplus equally with the seller: the second buyer earns his valuation less the price: $14 - 12 = 2$. The remaining 2 seemingly goes to the seller.

We assume initially that the parties' contract grants the initial buyer a right to specific performance for the property right price. Hence, this buyer can prevent the seller from trading with the second buyer. The seller thus must renegotiate to exit. Since the parties now have an additional 2 to share, the seller will pay the initial buyer a total of 3, his expectation of 2 plus the 1 that is the buyer's equal share of the seller's share of the marginal social gain from selling to buyer two. The seller also earns 3, the new price of 12 less her production cost of 6 and less the payment to the buyer of 3.

Now assume that the contract does not give the buyer a right to specific performance. It may seem that sharing will not occur. The seller will pay the buyer his expectation of 2 and trade with the second buyer, realizing a net gain of price less cost less damages, or $12 - 6 - 2 = 4$. Under this contract, the seller appears to capture the entire half of the marginal social gain from selling to the second buyer.

To the contrary, sharing also occurs when the buyer lacks a property right. The buyer's expectation in the example so far is 2 because the seller charges the property right price of 8. If the buyer does not have a right to specific performance, this price permits the seller to earn a pure profit of 1, the part of the marginal social gain from exit that she is not sharing.

Assumption (c), recall, holds that there are other sellers in the market. Any such seller has an

incentive to offer the the no-specific performance contract for 7.50. The buyer's expectation would become $10 - 7.50 = 2.50$, so he would prefer to trade with this seller. The seller would make a profit of 3.50 at the 7.50 price: bid of 12 from the later buyer less production cost of 6 and less expectation damages paid to the initial buyer of 2.50. This profit exceeds the profit of 3 that a seller who offers the specific performance contract would make. The illustrative seller thus would undercut the initial seller's price of 8.

The competitive process would not end at a price of 7.50, however, because the equilibrium price for a contract without specific performance is 7. To see why, suppose that a seller reduced the price to 6.50 when buyers lack a right to specific performance. The buyer's expectation then would be $10 - 6.50 = 3.50$, so the seller would earn $12 - 6 - 3.50 = 2.50$. The seller, however, earns 3 under the specific performance contract, so no seller would reduce the price below 7 for a contract without specific performance. And by the logic above, no seller could increase the price for a contract without specific performance to above 7 because any such price would be undercut. For example, when the illustrative seller charges 7.50, another seller could get the business of buyers by charging 7.25.¹⁶ But then another seller would charge 7.15, and so forth. Hence, the equilibrium price for a contract without specific performance is 7 and, by the same logic, the equilibrium price for a contract with specific performance is 8.

The buyer's payoff when the seller rejects trade thus is invariant to the legal remedy. When the buyer has a right to specific performance, he realizes his expectation of 2 ($10 - 8$) plus 1 in a renegotiation; when the buyer is only entitled to damages, his expectation rises to 3 ($10 - 7$). Critics of the expectation remedy fail to see that the two remedies have the same

¹⁶When the price is 7.25, the buyer's expectation is 2.75, so at this price the seller takes the second bid and earns $12 - 6 - 2.75 = 3.25$, which exceeds her specific performance gain of 3.

distributional consequence because they assume that sellers can charge property right prices - 8 in the example – when buyers lack property rights. The price, however, is a function of the rights the buyer actually has.

We next set out a model that performs three functions. First, it generalizes the example. Second, the example assumed that the property right price was 8 and the expectation price was 7; the model shows how such contract prices are formed. Third, the model is the basis for developing the second order reasons that cause promisees commonly to prefer sharing in the nontrading gain through the vehicle of lower prices rather than property right induced renegotiations.

2.2 An expectation interest model

A risk neutral seller and a risk neutral buyer, functioning in a competitive market, agree to trade an item of personal property.¹⁷ We begin with a simple contract, denoted “the standard contract,” that often is written today. This contract contains three sets of terms. The “action terms” describe the item that the parties expect to trade and set out the delivery steps the seller is to take. The “transfer term” specifies what the seller must pay to the buyer if the seller does not deliver the item. The price term specifies what the buyer must pay to the seller if the parties trade the item.

After the parties contract, they observe the realization of two random variables: the seller’s cost to produce (or acquire) the item and the value the buyer attaches to the item. If the seller chooses to trade, she tenders the item and the buyer pays the price. If the seller rejects trade, she pays the sum the contract’s transfer term specifies. The timing of the model is as

¹⁷The competitive market assumption simplifies analysis. We later relax the assumption to show that our conclusions apply in less competitive environments.

follows:

t^{-1} : The state moves by choosing a default transfer term. The state's goal is to enact the term that maximizes parties' gains from trade.

t^0 : The parties contract. At this time, they decide what transfer term to include in their contract.

t^1 : The parties observe the seller's cost of complying with the contract's action terms and the value the buyer would derive from performance of those terms.

t^2 : The seller chooses whether to trade or to transfer. If the seller trades, she tenders the item and the buyer pays the price.

t^3 : If the seller rejects trade, then (a) the seller transfers to the buyer the sum the contract directs, but (b) if the law were to enforce property right contracts and the parties were to use one, the parties would then renegotiate to share the nontrading gain.

The typical contracts we analyze set a single price. These contracts are obligatorily but not fully complete. To see what this means, let Θ denote the set of possible states of the world that may obtain at t^1 . Partition these states into two subsets: θ_A and θ_T . If the realized state θ that obtains at t^1 is in θ_A , trade is assumed to be efficient; if the realized state θ is in θ_T , trade is inefficient. When the contract has a single price, the seller may prefer not to trade in some of the efficient θ_A states; then her realized cost exceeds this price, though her cost is below the buyer's value. This contract is obligatorily complete because it fully describes the parties' obligations: the buyer must pay the contract price to the seller when the seller accepts trade, and the seller must pay the sum that the transfer term directs to the buyer when the seller rejects trade. On the other hand, the contract is not fully complete because it does not set prices for states in θ_A in

which the seller prefers to reject trade.¹⁸

Parties know the mean, denoted C , of the distribution of possible values that the seller's realized cost can take. There are two cost categories. If the parties expect at t^0 that a third party may appear to bid for the item, then C is the mean of possible bids; if instead the parties expect that the seller's production cost may vary, then C is the mean of possible production costs. Similarly, parties know the mean, denoted V , of the distribution of possible values that the buyer could come to have from performance of the contract's action terms. Since it would be inefficient for risk neutral parties to contract if the buyer's expected value is below the seller's expected cost, we assume that V exceeds C .

The parties expect to trade when the ex post state is in θ_A . The seller's expected θ_A cost is the low C_L and the buyer's expected θ_A value is the high V_H . Thus, at t^0 the parties expect the gain from trading the item to be $V_H - C_L$. We refer to this expected gain as a "surplus" and denote it S_a . Trade is inefficient if the ex post state θ is in θ_T ; then the seller's realized cost exceeds the buyer's realized value. Denote the seller's expected θ_T cost as the high C_H and the buyer's expected θ_T value as the low V_L . Thus, at t^0 the parties expect the "gain" from not trading to be $S_t = C_H - V_L$. This is the expected saving when the seller rejects inefficient trade. The probability that $\theta \in \theta_A$ is denoted β_a ; the probability that $\theta \in \theta_T$ is denoted β_t ; $\beta_a + \beta_t = 1$. The buyer's realized value is denoted v , the seller's realized cost is c , and the contract price is p .

¹⁸To clarify this point, we assume that the seller's realized cost is less than the buyer's value but may exceed the price in some states of the world that fall within the descriptor θ_A . A complete contract would set a price for every possible θ_A state. Since price would then exceed cost in every one of these states, the seller would prefer to trade in all of them. Contracts are incomplete – i.e., contracts leave some states unpriced – because there are an infinite number of possible future states but a finite amount of money to devote to contracting about them.

Parties make procurement contracts in order to trade, not to speculate on future states of the world. Therefore, we assume that parties expect the trading surplus to exceed the nontrading surplus and expect the probability of trade to exceed the probability of not trading.¹⁹ Parties behave efficiently if they trade when they are in Θ_A and reject trade when they are in Θ_T .

To complete the model, we suppose that if the parties litigate, the court observes the contract, whether the seller has accepted trade or made the required transfer, and the buyer's realized value. Hence, the court can enforce any transfer term, such as the current legal default, that conditions on the buyer's value. We make three further assumptions, the first two of which we later relax: (i) neither party is liquidity constrained; (ii) renegotiation and contracting are costless; (iii) the parties have equal bargaining power at the renegotiation stage.

3. Sharing Through the Price or Through a Renegotiation

Part 3 first recreates the result that protecting the promisee's expectation is efficient with respect to the parties' decision whether to trade. It then goes on to show that parties would make contracts with a transfer term that protects the expectation. Finally, Part 3 exhibits the sharing properties of these contracts and discusses their positive implications.

3.1. An efficient transfer term: Under the standard contract, the promisor can refuse trade

¹⁹Formally, $S_a > S_t$ and $\beta_a \in [\frac{1}{2}, 1]$. We assume that the state probabilities are exogenous. These assumptions about S and β importantly differ from the assumptions that underlie the regnant suspicion of the dual performance hypothesis. That suspicion, recall, follows from the view that parties contract in order to receive a performance, not to make a bet. This view is correct, but theorists who reject the hypothesis go on implicitly to suppose that parties at the contracting stage naively assume that the trade they prefer occurs with probability one. On this assumption, a contract need not be in the alternative. In contrast, the sophisticated parties in our model believe that trade is more likely than not, but they also know that trade may turn out to be inefficient.

if she makes a transfer to the promisee. An efficient transfer term would ensure in expectation that parties trade if and only if the value the buyer realizes from trade exceeds the seller's cost (i.e., iff $v > c$). Let the state, which moves first, choose a default transfer term, denoted r , that requires the seller to pay the buyer's realized expectation if the seller rejects trade: $r = v - p$. Suppose that the seller's cost turns out to exceed the price. If the parties' contract does not change the legal default, the seller accepts trade if her loss from trading is less than the transfer the default requires her to make. The seller trades, that is, if $c - p < r = v - p$, or if $v > c$, and she rejects trade when $v < c$. Under the default r , that is, parties always realize the higher of the two possible contracting surpluses: the trade surplus when trade is efficient; and the no-trade surplus when trade is inefficient. Therefore, a state that chooses damage rules in order to maximize the parties' gains from trade would select the transfer term r as the default for contracts that do not create property rights unless parties would reject this default.

3.2. Parties' preferences under the standard contract: The contract price divides a deal's expected surplus according to the parties' bargaining powers. The buyer, we assume, can command α of a transaction's expected surplus, where $0 < \alpha \leq 1$. The price thus awards the seller $1 - \alpha$ of the surplus.²⁰ Importantly, bargaining power is determined exogenously.²¹ Denote the

²⁰Buyers receive all of the expected surplus in competitive markets. To see why, recall that the buyer realizes his value less the price ($v - p$). In competitive markets, price is competed down to cost. Thus, the buyer actually realizes value less cost ($v - c$), which is the entire surplus. In the model, then, $\alpha = 1$ when the market is competitive and falls as competition declines.

²¹Bargaining power sometimes is determined structurally, as when a market is competitive. When both parties have bargaining power, we assume the bargaining is Nash: each party's relative bargaining power is a function of the parties' disagreement points and their discount rates. The party who can do better outside of

expected surplus under a contract as Z . Then the bargaining parameter α divides Z , but since the parties cannot affect the magnitude of α , they choose the nonprice terms to maximize Z . We have just shown that the transfer term r permits parties always to realize the higher of the two possible surpluses. Hence, parties would accept r as the legal default transfer term.²²

3.3. A property right contract

A property right contract, were it enforceable, would contain action terms and a price but lack a transfer term. Rather, the buyer would have a contract right to performance of the action terms. To see how this contract would function, assume that there is no performance right but

the deal commonly does better in it because the other party cannot persuade her to deal unless he accepts a contract that permits her to beat her outside offer. The more patient party also does better because she can wait longer for a favorable offer. Bargaining power is exogenously determined in these cases because neither party can affect either the value of her counter party's outside option or the rate at which the counter party discounts that value.

²²Parties do not make relation specific investments in our model because the law's critics do not consider these investments. The model is consistent with efficient investment incentives, however. When the buyer's value is verifiable, as is assumed in the literature we discuss, contracts can take forms such that the expectation interest remedy – i.e., the transfer term r – induces the parties to invest optimally. For reviews and analysis, see Suzanne Ohlendorf, "Expectation Damages, Divisible Contracts, and Bilateral Investment", 99 *Amer. Econ. Rev.* 1608 (2009); Alexander Stremitzer, "Standard Breach Remedies, Quality Thresholds, and Cooperative Investments", Mimeo (2008); MacLeod, *supra* note 7, at 602-03. There is a question why parties contract, rather than make spot purchases, when markets are thick. Our parties may contract to protect investment or to insure themselves against any disruption costs that the failure to trade could cause. This latter motivation is analyzed in Alan Schwartz and Robert E. Scott, "Market Damages, Efficient Contracting and the Economic Waste Fallacy," 108 *Columbia Law Review* 1610, 1643-47 (2008).

instead the contract's transfer term requires the seller to pay $r = \infty$ if she rejects trade. The buyer's gain from trade would be $v - p$. The seller, we showed above, can restrict the buyer to this payoff by trading, at a loss of $c - p$. Therefore, the parties would renegotiate to excuse the seller, though r is very large, if the seller can make a transfer to the buyer that gives the buyer a payoff that exceeds his trading payoff and that gives the seller a payoff that is less than her (negative) trading payoff.²³ Denote the set of possible transfers from the seller to the buyer as X . Any such transfer, $x \in X$, that would permit the seller to exit thus must satisfy $v - p < x < c - p$. Both inequalities cannot be satisfied unless $v < c$ (i.e., trade is inefficient).

This analysis supports two conclusions. To understand the first, realize that a promisee with a property right has as much power as a promisee who can enforce a very large transfer term. In both cases, the promisee can impose heavy costs on a promisor who refuses to trade or to pay. Therefore, in both cases, the promisor will either trade or offer the promisee a transfer for permission to avoid trade. No transfer that both parties will accept exists, we have just seen, unless trade would have been inefficient. The promisor thus trades under a property right contract when trade is efficient and makes a monetary transfer to avoid trade when trade is inefficient, just as promisors do today under the standard contract. The second conclusion is that the buyer's renegotiation payoff under a property right contract exceeds his trading gain: $x > v - p$.

Before discussing surplus sharing we note that these conclusions hold for every type of property right contract. The buyer's share of the nontrading gain is the same under each of them. The buyer's right, it is sometimes suggested, should be protected by awarding him punitive damages when the seller fails to perform. We have just shown, however, that a penalty of infinity

²³Recall our assumption that renegotiation is costless.

functions as the specific performance remedy functions. Neither remedy causes the seller to perform inefficiently, and under both she exits by paying to the buyer a sum that is between the buyer's gain from trade and the seller's loss from trade. Similarly, a seller would trade inefficiently if the buyer's disgorgement remedy transferred the full gain from not trading to the buyer; but again the seller escapes inefficient trade by paying to the buyer a sum that is between the buyer's trading payoff and below the seller's disgorgement loss. Invariance among remedies exists because the buyer's payoff from renegotiation is a function of (a) the nontrading gain; (b) the trading gain; and (c) the buyer's bargaining power in the renegotiation.²⁴ These variables do not vary with the particular remedy the buyer invokes to trigger a renegotiation. Hence, the buyer's payoff is the same under all property right contracts.

3.4. Surplus sharing and the buyer's expected return

3.4.a: Intuition

A property right contract gives the buyer bargaining power ex post because he can compel the seller to perform. A market gives the buyer bargaining power ex ante because he can buy from the seller who offers the best terms. To compare the payoffs that these different forms of bargaining power imply, we assume that the law enforces both contract types. Let a seller offer the standard

²⁴The parties' bargaining powers ex post differ from their ex ante powers because their disagreement points change. The seller, in a renegotiation, can restrict the buyer to his expectation by trading and the buyer may lack immediate access to the market to replace the seller's performance. Hence, both parties have bargaining power later. In the model's terminology, $0 < \alpha < 1$ for the buyer and is $1 - \alpha > 0$ for the seller. For convenience, we let $\alpha = 1/2$. An analysis of how a buyer's bargaining power can fall after making a contract is in Alan Schwartz, "Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies", 21 J. Legal Studies 271 (1992).

contract, which does not convey a property right, *but* charge the buyer the “property right price”.

This price permits the seller to recover three categories of expected cost: (a) the seller’s cost of trade if the seller trades; (b) the seller’s cost of paying the buyer’s expectation if the seller rejects trade; and (c) the *additional* cost that the rejecting seller later incurs because she must pay the buyer a share of the nontrading gain in order to exit. Since the payment of this share is a cost, it is reflected in the property right price.

Standard contracts with such property right prices would not exist in equilibrium, however. Sophisticated buyers anticipate the possibility of two possible surpluses: one that trade creates and the other that rejecting trade creates. If one seller offered a standard contract at a property right price, a competing seller could get the business of a sophisticated buyer in either of two ways. First, she can retain the price but offer the buyer a property right contract, that would permit the buyer to get specific performance or disgorgement. Buyers prefer property right contracts at property right prices to standard contracts at property right prices because the property right contract permits the buyer actually later to acquire a share of the nontrading gain. Second, the putative competitor can offer the standard contract at a lower price.

We focus on price reductions. Recall that the property right price aggregates three cost categories. When a seller charges a property right price without offering a property right, however, category (c) is not real cost but a pure profit: the buyer’s share of the nontrading gain that the buyer actually lacks the power to compel. As the introductory example showed, this profit will be competed away. Another way to put this result is that price equals cost in competitive markets. Hence, price under the standard contract aggregates only cost categories (a) and (b) above.

The buyer’s expected payoff therefore is invariant to the contract type he accepts. Under the

property right contract, the buyer pays a price that includes the buyer's expected share of the nontrading gain, *but* he later recovers back this share in the renegotiation that he is able to force. Under the standard contract, the buyer cannot force a renegotiation *but* the price is lower by the buyer's expected renegotiation share. The value the buyer would realize from the seller's performance is unaffected by the contract type he signs. It thus follows that the buyer's expected payoff is the same under both contract types. Part 3.4b next sets out this reasoning formally. Readers for whom the formal analysis is unnecessary can turn to Part 3.4.c, which contains a more detailed numerical example, or skip directly to Part 3.5, which discusses the results.

3.4.b: Analysis

A buyer's expected return is the value he expects the goods to create for him less the price he has to pay. In the model here, the buyer's value is exogenous. For example, his value may be a function of demand for the end product the buyer plans to sell. The contract type the buyer accepts thus can affect his expected return only through the remedy it creates and the price. Sellers in competitive markets earn a return on invested capital, which is reflected in their costs, but otherwise earn zero profits. We next solve for the prices under the two contract types on this zero profit assumption.

The seller's expected return under the property right contract is

$$(1) E_S(\pi_{pr}) = \beta_a(p_{pr} - c_L) - \beta_t\{(v_L - p_{pr}) + \alpha[(c_H - p_{pr}) - (v_L - p_{pr})]\}$$

The first term on the right hand side of expression (1) is the seller's expected return from trade: the property right price, denoted p_{pr} , less the cost the seller incurs in the trading state. The entire term in braces is the payoff the seller must make to the buyer in the nontrading state. The first term in braces is the buyer's nontrading state expectation: his low value less the price. The first bracketed term is

the seller's saving from rejecting trade – her high nontrading cost less the price. The second bracketed term is the buyer's expectation, which must be deducted because the seller must pay it, as is reflected in the first term in braces. All of the terms in braces are multiplied by β_t , the probability that the parties do not trade. The bracketed terms also are multiplied by α , the buyer's bargaining power, because those terms reflect the payment the buyer can exact to permit the seller not to trade. The bracketed terms simplify to $c_H - v_L$, which equals S_t , the surplus from not trading. Using this simplification, that $\beta_a + \beta_t = 1$, and letting expression (1) equal zero to reflect the competitive market assumption, the property right price is

$$(2) \quad p_{pr} = \beta_a c_L + \beta_t v_L + \beta_t [\alpha (S_t)]$$

The first two terms in expression (2) represent the seller's expected cost if the parties trade and the seller's expected cost of paying the buyer's expectation if the parties do not trade. The last term is the expected cost of the bribe the seller must later pay to the buyer in order to avoid trade: that is, the expected value of the nontrading gain the buyer's bargaining power under a property right contract permits him to capture. This bribe is reflected in the price because it is a cost the seller incurs under the property right contract.

The seller's expected return under the standard contract is

$$(3) \quad E_S(\pi_{ei}) = \beta_a (p_{ei} - c_L) - \beta_t (v_L - p_{ei})$$

The first term on the right hand side is the expected value of the seller's gain from trade: the standard contract price, denoted p_{ei} , less the seller's cost in the trading state. The second term is the buyer's nontrading state expectation, which the seller must pay when she rejects trade. Letting expression (3) equal zero, the expectation interest price under the standard contract is

$$(4) \quad p_{ei} = \beta_a c_L + \beta_t v_L$$

Again, the first two terms reflect the seller's expected trading cost and the seller's expected payment of the buyer's nontrading state expectation. There is no third term, however, because under the standard contract the seller need not pay a bribe in order to exit.

Were a seller to offer the standard contract at the price of a property right contract, she would make a pure profit, above her cost, of $\beta_t[\alpha(S_t)]$. The seller, that is, would be compensated for a bribe that she need not later pay. Other sellers would compete this profit away by offering lower prices, however. The equilibrium price under the standard contract thus is lower than the price under the property right contract by the buyer's expected share of the nontrading gain.

The buyer's expected gain under the standard contract is his expected value, denoted V , less the expectation interest price:

$$(5) E_B(\pi_{ei}) = V - p_{ei}$$

The buyer's expected gain under the property right contract is his expected value plus his share of the nontrading gain if the parties renegotiate rather than trade and less the property right price:

$$(6) E_B(\pi_{pr}) = V + \beta_t(\alpha S_t) - p_{pr}$$

The two gains are equal: that is, Expression (5) minus Expression (6) = 0.²⁵ Regarding the intuition, the buyer's expected value is the same under both contract types. Hence, in this model, the buyer is indifferent between receiving his value less the low expectation interest price, or receiving his value less the high property right price, but later recovering the difference between the prices in a renegotiation.

Finally, although it is convenient to assume a competitive market in demonstrating this result,

²⁵Doing this subtraction, we have $(V - p_{ei}) - (V - p_{pr} + \beta_t(\alpha S_t)) = p_{pr} - p_{ei} - \beta_t(\alpha S_t)$. Recalling that $p_{pr} = p_{ei} + \beta_t(\alpha S_t)$,

(5) - (6) = 0.

the result applies broadly. The model is driven by three factors: (i) the buyer has bargaining power ex post; (ii) the seller can charge a price that is at least as high as the seller's expected cost; and (iii) the seller's ability to price ex ante is constrained by the existence of other potential suppliers. The first two of these factors hold everywhere and the last holds unless a seller has strong monopoly power. Hence, buyers are indifferent between the two contract types in workably as well as perfectly competitive environments.²⁶

3.4.c: An example

In the example, which uses the competitive market assumption, the seller's cost will be 100 with probability .8 and 150 with probability .2. Hence, the seller's expected cost is $C = 110$. The buyer's value will be 145 with probability .8 and 120 with probability .2. Hence, the buyer's expected value, V , is 140. Since $V > C$, the parties contract. The parties trade with probability .8 because then the buyer's value is 145 and the seller's cost is 100. The buyer has 50% of the bargaining power if the parties renegotiate. In the model's notation, $c_H = 150$; $c_L = 100$; $v_H = 145$; $v_L = 120$; $\alpha = .5$; $\beta_a = .8$; β_t

²⁶We have verified this reasoning by solving for the contract prices under the assumptions that bargaining power is exogenous and that the seller can price so as to extract a share of the expected surplus from transacting. The price difference again equals $\beta_t[\alpha(S_t)]$. The most common workably competitive environment probably occurs when sellers engage in differentiated goods, Bertrand competition. In such markets, many sellers exist, each of whom differs on a dimension relevant to the buyer. For example, the buyer is purchasing a machine. Seller/manufacturers differ in their ability to match the machine to the buyer's needs. Hence, the seller that the buyer initially picks can capture some of the surplus that the buyer realizes from dealing with her rather than with the buyer's second choice. The phrase "Bertrand" indicates that the sellers compete on price. If the initial seller demands too much of the expected surplus from contracting with her, the buyer will turn to another seller, who would charge less. Competition thus again constrains a seller's bargaining power.

= .2. The surplus if the seller rejects trade is $S_t = c_H - v_L = 30$.

If the parties write a standard contract, the price, from Expression 4 above is $p_{ei} = .8(100) + .2((120)) = 104$. If the parties write a property right contract, the price, from Expression (2) is $p_{pr} = .8(100) + .2((80)) + .2[.5(30)] = 107$. The buyer's expected gain under the standard contract, from Expression (5), is $140 - 104 = 36$. The buyer's expected gain under the property right contract, from Expression (6), is $140 + 3 - 107 = 36$. The buyer thus is indifferent between agreeing to pay 104 under the standard contract but recovering nothing later, or agreeing to pay 107 under the property right contract but expecting with probability .2 to recover 15 back in a later renegotiation. The price adjusts to reflect the contract the buyer accepts, so the buyer makes the same expected gain under both contract types.

3.5. *Critiques of contract law and surplus sharing*²⁷

The view that current contract law precludes surplus sharing either is inconsistent with rationality or rests on an undefended premise. Rational, informed buyers know that contracting creates two possible surpluses. Let competitive sellers offer the standard contract to these buyers. This contract will have the efficient transfer term and a price that permits the buyers to share in the expected value of the gain that parties create when they do not trade.

²⁷ We focus here on positive concerns with these critiques. Part IV presents a more complete analysis of the moral critiques.

Suppose instead that some buyers focus only on the gain that trade yields, and do not realize that there can be a gain if the seller rejects trade. We call such buyers naive. If enough naive buyers exist, sellers would maximize profits by exploiting them at the cost of losing the business of the sophisticated buyers. In the resulting equilibrium, the standard contract would be offered at the property right price: buyers then would not share in the nontrading gain. The claim that contract law excludes promisees from sharing in this gain because the law protects only the promisee's expectation therefore holds *only* if too few sophisticated buyers exist to compel sellers to charge competitive prices.²⁸

It is an open question whether enough sophisticated buyers exist. Most contract theories, including those implicit in arguments that contract law should give promisees a property right in trade, assume that promisees have the ability to choose action terms that are in a promisee's best interest; for if promisees make irrational choices regarding the contract's substance, there seems not to be a well grounded property right to protect. Choosing the action terms, however, requires

²⁸The text uses the phrase "too few" because, when parties do not bargain at the contracting stage, sellers may offer optimal contracts in markets that both sophisticated and naive buyers enter when there are enough sophisticated buyers. See Alan Schwartz, "How Much Irrationality Does the Market Permit?", 37 J. Legal Studies 131 (2008). Irrationality plays a smaller role when there is ex ante bargaining. See John A. List and Daniel Millimet, "The Market: Catalyst for Rationality and Filter of Irrationality", The B.E. Journal of Economic Analysis & Policy, Vol 8:Iss.1, Article 47 at 3 (2008) ("[W]e conclude that individual irrationality as measured in our experiment does not unduly influence aggregate efficiency in bilateral bargaining markets.") It is sometimes said that naivety takes the form of an unawareness of a contract's remedial structure because parties at the contracting stage focus on performance rather than breach. The Introduction to Part 4 below contests this claim.

forward looking thinking. A promisee who is looking ahead should realize that trade under a contract is uncertain and thus ask how his contract regulates the no trade possibility. This reasoning suggests that competition works as explicated above, on the assumptions that the critics make. The issue is empirical, however.

Regarding the undefended premise, contract law's protection of the expectation interest permits rational promisees to share in the nontrading surplus through the vehicle of a lower contract price. A property right would permit rational promisees to share in the nontrading surplus through the vehicle of an ex post renegotiation. Hence, the dual performance hypothesis is plausible if promisees often prefer sharing through a price reduction. We next argue that, were sellers permitted to offer both contract types, many buyers would prefer lower prices.

3.6. The buyer's preferences

In the pure world of the model, which reflects the pure world of the critics, the buyer is indifferent between receiving a share of the surplus from rejecting trade in the form of a price reduction under the standard contract or in the form of an ex post transfer payment under the property right contract. We now relax some of the model's assumptions, to argue that sharing through the price would be the more common preference.

3.6.1: Ex Ante: costly contracting

We have assumed that contracting is costless. When this unrealistic assumption is relaxed, the standard contract becomes more attractive because it is cheaper to create. There are two reasons. First, the standard contract conditions on fewer states of the world. The buyer pays the price if the seller trades, and the seller pays the transfer if she does not. Thus, there are two possible payoff relevant states under the standard contract: trade or no trade. The property right

contract conditions on as many as six payoff relevant states of the world, of which the first two are trade and no trade. If the seller rejects trade and retains the subject of sale, the buyer is entitled to specific performance; if the seller has sold the subject of sale to a third party, the buyer is entitled to disgorgement. Hence, the property right contract also conditions on the states “sale” or “no sale”. Finally, if the promisor is quantity constrained – she cannot immediately expand output – she may be unable to perform for the promisee because she is performing for another. In this case, specific performance is impossible and disgorgement may be impossible as well (because the seller is not earning a pure profit), so the promisee is restricted to damages. Thus, the property right contract also may condition on the states “disabled” or “not disabled”. In consequence of this possibility, the contract requires a transfer term or the parties must decide to accept the current default, just as occurs when parties write the standard contract. The cost of creating a contract is increasing in the number of contingencies that the contract requires to govern the parties’ behavior.²⁹

Second, the pricing problem is more costly to solve under the property right contract. Comparing Expressions (2) and (4) above, under the standard contract the seller, in order to price, must predict her low cost and the buyer’s low value. Under the property right contract, the seller also must predict the nontrading state gain and the parties’ renegotiation bargaining power shares. Pricing the property right contract thus is more complex, and so more costly, than pricing the standard contract.

To summarize, though the value the buyer receives from trade is independent of

²⁹For a deeper analysis see Pierpaolo Battigalli and Giovanni Maggi, “Rigidity, Discretion and the Costs of Writing Contracts”, 92 *American Econ. Rev.* 798 (2002).

contractual form, his net payoff may not be. The property right contract price will often be higher than the standard contract price by the additional cost of writing and pricing the property right contract. Buyers prefer the standard contract when it yields the same payoff as the property right contract but is cheaper to create.

3.6.2: Ex Post

The background idea is that parties' interests change as they move from the ex ante to the ex post stage. Those interests are harmonious at the contracting stage: the parties anticipate that they will realize the relatively large trading gain, and so they share a desire to reach agreement.³⁰ The parties' interests are adverse at the ex post stage, however: they know then that they will not trade, and that they are engaged in a zero sum bargaining game. Every dollar that the buyer receives as damages or from a renegotiation is a dollar lost to the seller.

In the model above, the zero sum nature of the ex post game did not matter because the seller was assumed able to make whatever transfer the contract implies. A seller may become liquidity constrained after a contract is made, however. Such a seller's reluctance to transfer is increasing in the amount at stake. Under the standard contract, the buyer's ex post payoff is $v_L - p_{ei}$, his nontrading state valuation less the standard contract price. In the example above, that payoff is $120 - 104 = 16$. Under the property right contract, the buyer's payoff is $v_L - p_{pr} + \alpha S_t$, the buyer's valuation less the property right contract price plus the buyer's share of the nontrading

³⁰Recall our assumptions that the probability of trade exceeds the probability of not trading and that the trading gain exceeds the saving from rejecting trade. The parties' interests are not identical: sellers prefer high prices, for example, and buyers low. But because contracting creates a surplus, the parties play a positive sum game. They share an interest in "getting to yes."

gain. In the example above, that payoff is $120 - 107 + 15 = 28$, which is 43% higher.

The seller's reluctance to pay is heightened when, as sometimes happens, her costs are correlated across contracts. A seller may face bankruptcy if her costs on many contracts turn out to exceed the prices she has charged. Since more dollars are involved under the property right contract, a seller party to this contract is more likely to fight even harder to avoid her obligations in the correlated cost case. Turning to the contracting stage, parties seldom are aware of their counter-party's complete financial circumstances. Buyers under both contract types thus face risk that their seller will turn out to be liquidity constrained. This risk is lower under the standard contract than under the property right contract because there is less at stake under the standard contract. For this reason also, the buyer is inclined to prefer the standard contract.

In addition, the model above assumed that the seller makes a transfer immediately after she rejects trade and that renegotiation occurs instantaneously. In a more realistic framework, the seller has an incentive to delay, and renegotiations take time. The buyer may be disadvantaged by delay if he expected to use the contractual transfer to purchase a substitute or to pay off a lender. Delay is more likely when the buyer requires a renegotiation to be paid. The standard contract thus poses a lower delay risk.

To sum up, a seller who is financially constrained has an incentive to resist payment and all sellers have an incentive to delay payment. Resistance or delay may take the form of a claim that the seller made a conforming tender that the buyer unreasonably rejected, or that her cost increases were sufficiently material as to make performance impractical, or that the buyer was not ready to receive timely delivery. Such strategic behavior is more likely to occur, or be more serious, under the property right contract. Therefore, ex ante and ex post considerations would

cause many buyers to prefer the standard contract if the market offered both contract types.

We summarize the analysis in two Propositions:

Proposition 1: Current contract law permits a promisee to share in the surplus that a promisor's rejection of trade creates just as fully as he could share if he had a property right in the promisor's performance.

Proposition 2: If contract law were to make the expectation remedy the default, the typical promisee would let the default stand when the promisee could prove his expectation.³¹

We make two further comments. First, a promisee's gross payoff is the same under either contract type, so parties prefer the contract that yields the highest net payoff. The standard contract yields the highest net payoff because it is cheaper to create and to enforce. This analysis supports the dual performance hypothesis. The promisee *prefers* the standard contract, under which the promisor may choose whether to perform the contract's action terms or to make a transfer to the promisee in the amount of his expectation. Using the vocabulary of contract, the promisee *agrees* to give the promisor this choice, so that it is not a breach when the promisor exercises the choice in favor of paying money. This is the dual performance hypothesis.

Second, parties prefer the property right contract when asymmetric information prevents the promisee from proving his expectation. Our model assumes that parties observe the expected and the ex post values of the cost and value variables. Importantly, courts also can observe the

³¹Proposition 2 is phrased in this way because the expectation remedy is not a default, but rather is the only available remedy. Courts will not enforce specific performance contracts, and will not enforce liquidated damage clauses that fail reasonably to approximate the expectation. The Proposition follows from the model,

promisee's ex post value: the gain the promisee would have realized had the parties traded.³² A court thus can award the promisee this value less the price when the promisor rejects both trade and transfer. Now suppose that the promisee's realized value is unverifiable. Then, the court could not protect his expectation, which creates an incentive for the promisor to reject both trade and transfer. Parties attempt to solve the verifiability problem today with liquidated damage clauses and suits for specific relief. Courts regulate the former and sometimes deny the latter. Our model shows that, in the asymmetric information case, parties would benefit from the ability to contract for an enforceable property right in the promisor's performance.³³

We sum this analysis up with the claim that the standard contract is consistent with the majority preference. Hence, if parties could contract for any remedy they wish, the standard contract should be the default. Critics of the expectation remedy, in contrast, argue that the property right contract either should be the default or mandatory. Parties would be made worse

which assumes that both contract types are enforceable and argues that buyers commonly would prefer the standard contract.

³²This is v_L in the analysis above.

³³One of us, in an earlier article, argued that courts should enforce specific performance contracts and that specific performance should be available on demand. See Alan Schwartz, "The Case for Specific Performance", 89 Yale L. J. 271 (1979). In the modern lexicon, the latter claim held that specific performance should be the default. This claim primarily rested on the argument that (a) expectation damages – value less price – cannot be awarded when value is unverifiable; (b) market damages – the price of a substitute – cannot be awarded when no close substitutes exist; and (c) buyers seek specific performance only when factor (a) or factor (b) obtains. As the text above shows, parties would contract for specific performance in these cases, and courts should enforce their contracts. Our current article, using modern theory, shows that parties prefer standard contracts when the two key factors do not obtain.

off in either case.

4. The Normative and Moral Structure of the Expectation Remedy

The model above reveals that the dual performance hypothesis best explains how parties contract. A seller make a promise in the alternative: to provide goods or services to the buyer or to make a monetary transfer to the buyer in lieu of the goods or services. Accordingly, a promisor who voluntarily implements the transfer rather than the action terms does not breach her contract but *performs* it; and a court that, imposing the expectation remedy, orders a recalcitrant promisor to make a transfer provides not substitutionary but *direct* relief.

Part 4 applies this understanding of the contractual relationship to defend the expectation remedy, understood in terms of the dual-performance hypothesis, against two prominent philosophical criticisms. On the analytic level, which concerns the law's normative structure, critics claim that the expectation remedy prices a breach of contract when the law instead should sanction the breach. Moreover, the legal price is set so low as to encourage breach rather than deter it. The intrinsic normative force of a contract law derives largely from its commitment to the performance of contracts. Hence, the expectation remedy, by its slighting of performance, undermines the very legal order to which it belongs. On the level of morality, which concerns extra-legal ideals to which the law must answer, critics claim that the expectation remedy's slighting of performance violates the moral order governing the promises that contracts typically involve.

We contest both of these claims. It is helpful to begin by refuting a premise of the critical approach. This premise holds that when parties create contracts they restrict their focus to what

the promisor agrees to do and the price. It follows that parties should be taken to have no conscious intention regarding remedies unless a contract speaks directly to the remedy issue. The dual performance hypothesis assumes, in contrast, that the promisee *agrees* to accord the promisor discretion to trade or to transfer. If promisees actually are inattentive to remedies at the contracting stage, the hypothesis thus seems implausible.

This “inattention premise” is mistaken; promisees very likely attend to remedies. To see why, recall the description of the two types of contracts we model: the standard contract and the property right contract. The standard contract has (a) action terms; (b) a transfer term; and (c) a price. The property right contract, if enforceable, would have (a) action terms; (b’) a grant of a property right; and (c) a price. The price in the standard contract is a function of terms (a) and (b); the price in the property right contract is a function of terms (a) and (b’). A sophisticated promisee asks what the contract price buys him. He cannot rationally answer this question without considering *both* the (a) terms and the (b) terms. Put more directly, the assumption that parties are sophisticated and the assumption that parties ignore the no trade contingency are inconsistent.

Therefore, assuming sophistication the transfer term arises out of the parties’ actual intentions, and not just out of intentions that it would be rational for them to have or fair to impute to them. The transfer promise, that is, is as real, as much a product of the parties’ actual intentions, as the promises that govern trade. This promise is memorialized in the standard contract through the price term, which fixes the gain to buyers both of trade and of transfer (since the contractual transfer equals the value that trade would have yielded less the price). We actually are tempted by the view that the transfer promise is express – that given the parties’ negotiations,

the price term just *is* a liquidated damages clause, which fixes transfers by reference to the named price (and its associated promisee surplus). Moreover, and critically, even if the transfer term is not express but rather implied from the price, it is implied *in fact* and not just in law. Part 4 uses these ideas to reinterpret the expectation remedy along lines that answer the remedy's critics. We show that on our interpretation the expectation remedy sanctions rather than prices breaches, when a breach is understood as the promisor's failure both to trade and to transfer. Hence, the expectation remedy is consistent with the normative structure of contractual obligation. Moreover, we give the expectation remedy an interpretation that renders it formally consistent with the morality of promise. Finally, we argue that the style of sharing that the expectation remedy introduces into the contract relation better serves the substantive values associated with the morality of promising than its alternatives, at least for the case of exchanges of commercial promises among sophisticated parties interacting at arms length in an open, flexible economy.

4.1 The Analytic Claim

Critics of the expectation remedy assert that the remedy is inconsistent with the internal (or, as we sometimes say, immanent) normative structure of contract law. This is an analytic point rather than a moral one, referring to the norms immanent in contract rather than to contract's connection to moral values that reside outside of the law. We take up the morality of the expectation remedy in Section 4.2 below. In this Section, we first set out the leading analytic concerns, and we then show how our reconstruction of the doctrine dissolves these concerns.

Critics argue that expectation damages merely *price* breach rather than fix the *sanction* to

be imposed on a wrongful breach.³⁴ Melvin Eisenberg thus remarks of the law's encouragement of refusals to trade: "if you don't wish to take a promised action when it is due, because all things considered you believe that the cost to you of taking the action would exceed the gain to the promisee, *you shouldn't keep the promise.*"³⁵ Eisenberg adds that this "is not only an effect of the theory of efficient breach, it is a purpose of the theory."³⁶ In its self-presentation, the theory of "efficient breach" encourages the thought, as Farnsworth puts it, that "a 'mere' breach of contract is not a 'wrong.'"³⁷

Critics (turning the theory of "efficient breach" against itself) insist that this thought is inconsistent with the idea that contracts confer on promisees a normative power to demand performance. Contract law's immanent structure, so the critics claim, commits it to the

³⁴An early version of this claim appears in Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. Legal Stud. 1, 1 (1989). For more recent treatments of the claim, see Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 Yale L. J. 568, 591-92 (2006); Jody S. Kraus, *A Critique of the Efficient Performance Hypothesis*, 116 Yale L. J. Pocket Part 424 (2007).

³⁵Melvin Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law* 93 Cal. L. Rev. 975, 1012-13 (2005) (emphasis in original). Eisenberg has forcefully advocated for broader recourse to disgorgement. See Melvin Eisenberg, *The Disgorgement Interest in Contract Law*, 105 Mich. L. Rev. 559 (2006).

³⁶Eisenberg, *supra* note 36, at 1013. Here Eisenberg quotes Birmingham, whose article introducing the idea of efficient breach observed that "[e]ncouragement of repudiation where profitable through elimination of moral content from the contract promise might also be socially desirable." Robert Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 Rutgers L. Rev. 273, 292 (1970).

³⁷E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 Yale. L.J. 1339, 1341 (1985).

proposition that breach is objectionable and must be sanctioned, which is the formal opposite of the expectation remedy's encouraging attitude towards "efficient breach." The conceptual core of this criticism lies in the idea that a contract's action terms exhaustively characterize the promisor's obligations, so that money damages necessarily are substitutionary relief. It is common to hear critics, pursuing the thought that the phenomenon of "efficient breach" places the expectation remedy at odds with the normative structure of contract, echo approvingly the UCC's observation that "the essential purpose of a contract between commercial [parties] is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit."³⁸

The ideas that a promisor who tenders a transfer of the expectation is in breach and that the expectation remedy encourages efficient breaches have surprising staying-power, retaining their hold even on those who appear self-consciously to try to shake them loose.³⁹ We now give

³⁸UCC § 2-609 cmt. 1 (2003). A recent example is Melvin Eisenberg, supra note 36, at 1007. Eisenberg cites an influential treatise on restitution, which claims that "In most contracts, . . . [t]he expectation that deserves protection is the promised performance" 3 George Palmer, *The Law of Restitution* s. 15.9 at 440 (1978). This remark repeats the ambiguity in the UCC comment.

³⁹The modern originator of that theory, Robert Birmingham, introduced the argument for the expectation remedy's efficiency by writing that "[r]epudiation 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 the performance been rendered." See Birmingham, supra note 63, at 274 (emphasis added). And Richard Posner, who has perhaps been the theory of efficient breach's most prominent promotor, cast the efficiency of the expectation remedy as involving a similar assault on the idea that the law requires contracts to be kept: "If [a promisor's] profit from breach would . . . 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

two examples of prominent commentators who acknowledge that a promisor's voluntary payment of the promisee's trading gain might constitute an alternative form of performance, but also, in the same breath, characterize the payment as a remedy for breach, not an alternative form of specific performance.⁴⁰ Working through the examples helps to establish a contrast between the traditional theory of efficient breach, which is subject to the analytic objections raised by critics, and the dual performance hypothesis, which is not.

We begin with Holmes's famous suggestion that "[t]he 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."⁴¹ As he took this view of the positive law, however, Holmes also supposed that his account put contract in tension with morality, which requires that promises be kept. Thus, Holmes's famous remark about contract is sandwiched between less-noticed claims that the suggestion that contracts must be kept represents "the confusion between legal and moral ideas,"⁴² propagated by

breach. There should be." Richard Posner, *Economic Analysis of Law* (1st ed. 1972) at 57 (emphasis added).

The most recent edition of Posner's *Economic Analysis of Law*, though it reflects many changes in the characterization of the expectation remedy's efficiency, retains unchanged the thought that the conduct the remedy encourages, though efficient, involves a breach of contract, and therefore that the remedy itself provides substitutionary relief.

⁴⁰A similar phenomenon appears in the Restatement, in the comments to § 361, which recognize that a promise in the alternative gives promisors a privilege to transfer rather than to trade but also characterize the transfer as a breach.

⁴¹Oliver Wendell Holmes, *The Path of Law*, 10 Harv. L. Rev. 457, 462 (1897). See also Holmes, *The Common Law* 300-01 (M. Howe ed. 1963) (1st ed. Boston 1881).

⁴²Oliver Wendell Holmes, *The Path of Law*, 10 Harv. L. Rev. 457, 462 (1897)

“those who think it advantageous to get as much ethics into the law as they can.”⁴³ Holmes, in other words, did not follow his doctrinal insight that a contract is merely a legal obligation in the alternative backwards to its source, that the contract itself contains alternative promises, so that making the transfer that the contract requires is a form of performance. Holmes in his letters denied holding this view, complaining of “the persistence of the impression that I say that a man *promises* either X [to trade] or *to pay damages*.”⁴⁴ Instead, Holmes insisted: “I don’t think a man promises to pay damages in contract any more than in tort. He commits an act that makes him liable for them if a certain event does not come to pass, just as his act in tort makes him liable *simpliciter*.”⁴⁵ We embrace the expectation remedy as Holmes did, but reject his view of contracts’ promissory content, and hence also the view that the expectation remedy puts contract law at odds with promissory morality. As we argue in greater detail below, the view that a contract contains two promises permits the expectation remedy to put as much ethics into legal doctrine as any other reasonable alternative.

Steven Shavell also has identified the doctrinal confusion associated with the idea of “efficient breach” only be drawn back into it. Shavell observes that “because all contracts are incomplete, that is, do not explicitly address many contingencies, one cannot automatically say that a person has made a promise to do . . . a particular thing in a problematic contingency even

⁴³Id.

⁴⁴Oliver Wendel Holmes, Letter of 11 December 1928, in 2 Oliver Wendell Holmes and Frederick Pollock, *Holmes-Pollock Letters: The Correspondence of Mr. Justice Holmes and Sir Frederick Pollock 1874-1932* (Mark DeWolfe Howe, ed.) 233 (1942).

⁴⁵Id.

though the contract in a formal sense imposes an obligation to perform.”⁴⁶ Moreover, he argues, where the costs to the promisor of performing a contract in an unaddressed contingency exceed the value of performance to the promisee, the parties would not have required performance in that contingency if they had addressed it in their contract.⁴⁷ Finally, Shavell observes that “we can deduce from the fact that the party in breach was willing to pay the expectation measure of damages that [performance cost her more than its value to her promisee, so that] . . . the parties likely would not have stipulated performance had they addressed the contingency that arose.”⁴⁸ Because Shavell believes, plausibly, that “if a contract does not address a contingency, then the moral duty of a party if the contingency arises is determined by what the contract would have said had it provided explicitly for the contingency,”⁴⁹ he concludes that the willingness of a promisor to pay expectation damages in a particular contingency implies that she has no moral obligation to perform [the action terms] in that contingency.

Shavell goes on to claim, however, that the failure of the promisor to perform those terms is a breach of contract.⁵⁰ His account of the expectation remedy thus also observes that there is a

⁴⁶Steven Shavell, *Specific Performance Versus Damages for Breach of Contract: An Economic Analysis*, 84 *Tex. L. Rev.* 831, 867 (2006). Shavell here refers to the distinction drawn above, between a contract that is only obligatorily complete and a contract that actually is complete. A contract that does not address “a problematic contingency” is only obligatorily complete. See also TAN at 19, *supra*, and note 19.

⁴⁷Steven Shavell, *Is Breach of Contract Immoral?*, 56 *Emory L. J.* 439, 441 (2006).

⁴⁸Steven Shavell, *Is Breach of Contract Immoral?*, 56 *Emory L. J.* 439, 441 (2006).

⁴⁹ Steven Shavell, *Is Breach of Contract Immoral?*, 56 *Emory L. J.* 439, 443 (2006).

⁵⁰ Sometimes, the view that the promisee is under conflicting moral and legal obligations is expressed almost simultaneously:

tension between law and morals in this area, although it is the reverse of the tension on which critics of the positive law base their objections to the expectation remedy.

In spite of this difference, Shavell's view that the tension exists, like more conventional views, rests on the incorrect premise that a contract that expressly specifies the action terms but not the transfer term legally obligates the promisor to perform specifically the action terms. This is the premise that leads Shavell to characterize the refusal to perform those terms as a breach. The contract that we and Shavell analyze – what we call the standard contract – creates two legal obligations, however. Contracting parties prefer that a promisor who faces the choice between trade and transfer will choose the outcome that maximizes surplus. The legal transfer term

In other words, under the expectation measure of damages for breach, the seller will fail to perform in the same contingencies as *the seller would be permitted not to perform* in a complete contract. Accordingly, *breach* should not be characterized as immoral under our assumptions.

Steven Shavell, *Is Breach of Contract Immoral?*, 56 Emory L. J. 439, 449 (2006) (emphases in original).

In a footnote to this passage, Shavell asks “what if a party breaches an explicit contingent provision of a contract and pays expectation damages?” Steven Shavell, *Is Breach of Contract Immoral?*, 56 Emory L. J. 439, 449 n20 (2006). He worries that in this case the breach would be both immoral (because the breached provision is explicit) and not immoral (because the payment shows, the explicit provision to the contrary notwithstanding, that the parties would not have agreed to require action in this contingency). Shavell resolves the “apparent conflict” by wishing it away, claiming that “it cannot happen that a party would be willing to pay expectation damages to breach a truly explicit contingent provision.” *Id.* He explains away observations of breaches in just such cases as involving various errors: that the expectation remedy is undercompensatory, for example, and so presents promisors with a possibility for opportunism; or that the provision in question has been misunderstood. *Id.* Our approach is simpler: we observe that a promisor may reasonably reserve for herself the right to pay expectation damages as an alternative form of performance even in contingencies in which, but for this reservation, she would have a primary duty to perform.

ensures this result by requiring the promisor to pay the promisee's gain from trade when the promisor rejects trade. As a consequence, if parties were free to contract over remedies, they would, we show above, accept the transfer term associated with the expectation remedy as their default. Indeed, to the extent that liquidated damage clauses are enforceable, parties today accept this transfer term when they eschew these clauses.

A contract is obligatorily complete when it expressly sets out obligations that apply in some contingencies and permits default obligations to apply in the rest. The standard contract is obligatorily complete in this way: it expressly obligates the promisor to perform the action terms when that would be efficient, and the contract uses the legal default to require performance of the transfer term when action would be inefficient. The tension in Shavell's analysis between law and morals dissolves because that tension rests on the incorrect premise that the standard contract does not create an obligation that governs in the no-trade contingency. To the contrary, the standard contract's remedy default requires the promisor to satisfy her contractual obligation by transfer in that contingency.⁵¹

Shavell's mistake, which others also make, causes him to treat the payment of expectation damages as an *epistemic tool* rather than a *normative feature* of the parties' contractual relation. He thus writes that when the law makes expectation damages the remedy for breach, then "we as onlookers know that when breach occurs, it must be moral, for we can *infer* that the cost of

⁵¹Shavell says, "In committing a breach and paying damages, the promisor would be acting in exactly the way called for by a complete contract." Steven Shavell, *Specific Performance Versus Damages for Breach of Contract: An Economic Analysis*, 84 *Tex. L. Rev.* 831, 867 (2006). The promisor actually acts in this way because the contract *is* obligatorily complete.

performance must have been higher than the value of performance from the willingness of the seller to commit breach.”⁵² But this suggests that if courts could measure costs and values directly, the expectation remedy might be done away with. Put another way, Shavell’s epistemic approach to the expectation remedy cannot justify the view that it is a *remedy*, and so in his analysis expectation damages are an epistemic tool whose use does not rest on a normatively sound foundation.⁵³ Our vindication of the dual performance supplies this foundation. When it is recognized that parties permit the promisor to make a transfer of the promisee’s trading gain in return for the right not to trade when trading would be inefficient, the analytic criticism of the expectation remedy falls.

If expectation damages were merely substitutionary, courts that award them would leave promisees with something other than what they have bargained for, and hence (perhaps) would undermine contract’s essential purpose. But because, as we have shown, expectation damages are in fact a species of direct relief – the specific enforcement of a contract’s (implicit) transfer term – courts that award them leave promisees with exactly one of the two possible things that they have bargained for.⁵⁴ The expectation remedy, properly understood, therefore is consistent with the fact

⁵²Steven Shavell, *Is Breach of Contract Immoral?*, 52 *Emory L.J.* 439, 450 (2006).

⁵³For a similar argument, see Seana Shiffrin, *Could Breach of Contract be Immoral?*, 107 *Mich. L. Rev.* 1551, 1556-59 (forthcoming 2009). This is not the only criticism Shiffrin levels against Shavell. Shavell responds to her essay, although not, we believe, to the features of her argument that overlap with ours, in Steven Shavell, *Why Breach of Contract May Not Be Immoral Given the Incompleteness of Contracts*, 107 *Mich. L. Rev.* 1569 (2009).

⁵⁴Here it is worth taking up an additional distinction in the margin. Ian Ayres and Gregory Klass rightly observe, in a context related to the current one, 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” Ian Ayres and Gregory Klass,

that promisees bargain for performance, and performance is what the remedy delivers to them. The remedy thus is consistent with the UCC's devotion to vindicating promises with direct relief, and it is also consistent with the analytic structure of contractual obligation that this devotion reflects.⁵⁵

Promissory Fraud without Breach, 2004 Wisc. L. Rev. 507, 513. Ayres and Klass marshal this observation against views, like ours, that understand contractual promises as (implicitly) promises to trade *or* to transfer. But although Ayres and Klass are right to observe that promisors typically intend to act, they do not sufficiently recognize that promisors have two types of intentions: concerning what they intend *to do* and concerning what they intend *to obligate* themselves to do. And while contractual promisors may well (for the good reasons Ayers and Klass report) typically intend to act, they have equally good reasons to obligate themselves either to act or to transfer. So Ayres's and Klass's accurate observation is not a valid objection to the view of contractual *obligation* that we develop.

We note, finally, that local criticisms aside, our position seems to us friendly to Ayres's and Klass's larger project, which, as their title suggests, is to explain how promissory fraud might arise in tort even where there are no violations of contractual obligations (in part because there might not be any contractual obligations to violate). Insofar as contract law focuses specifically on promisors' intentions to obligate, and promisors may have separate intentions concerning what they will do, Ayres's and Klass's tort theory fits naturally into a gap that contract necessarily leaves unfilled.

⁵⁵Jules Coleman recently argued that regarding a promisor's failure to perform a contract's action terms as a breach is consistent with the normative structure of contract, whereas it is not consistent to regard that failure as normatively innocent as long as the promisor performs the transfer term instead. See Jules L. Coleman, Some Reflections on Richard Brooks' 'Efficient Performance Hypothesis', 116 Yale L.J. Pocket Part 416 (2007). In Coleman's view, the expectation remedy follows a breach (hence the term "efficient breach"); therefore, the remedy functions as a sanction, remedying an action that the promisor has the capacity but not the right to do. Coleman rejects what he calls the option view – what we call the dual performance hypothesis – because the option view is inconsistent with the basic idea that contracts transfer to promisees the normative power to demand performance. His argument,

Our views thus reverse the traditional economic approaches to the expectation remedy whose structure Shavell's arguments lucidly reveal: whereas those approaches assimilate "efficient breach" to the *absence* of an obligation, we assimilate "efficient breach" to an obligation's *performance*; and whereas traditional economic theories of efficient breach understand the expectation remedy as a mechanism for identifying cases in which promisors are not obligated at all, we understand the expectation remedy as the direct enforcement of promisors' obligations to transfer. Rather than undermining the immanent normative structure of contractual obligation, the expectation remedy *directly* vindicates that structure.

4.2 The morality of contract: expectation damages, the wrong of breach and contractual solidarity

The moral criticism of the expectation remedy also assumes that the remedy provides substitutionary relief, at a level that encourages breaches, and it adds to the *analytic* claim the *moral* claim that encouraging breach is inconsistent with the external-to-law values involved in the morality of *promising*. Moralists thus claim that a promisor who pays (expectation) damages in lieu of trade converts her promisee's interest in the contractual performance to her own

however, assumes that the typical contract is a property right contract, under which the promisor agrees to perform the action terms unless some traditional ground for excuse obtains. We argue, to the contrary, that the standard contract is typical, and under it the promisee has only the power to require the promisor to pay if she refuses to trade. If we are correct in this positive claim, the law's interpretive premise that typical contracts are in the alternative poses no more threat to the normative structure of contract than giving a promisor the right to perform either of any two acts.

benefit.⁵⁶ Put more simply, expectation damages permit promisors to profit from something that no longer is theirs. Principles of fidelity or faithfulness require promisors to do what they say they will do, however. It follows that specific performance or restitution (its cognate) are the appropriate remedies for breach of contract.

These views are held by a broad range of commentators, including economists who doubt the moral foundations of the traditional economic analysis of contract remedies,⁵⁷ moralists who agree that the economic characterization of efficient breaches correctly captures the positive law,⁵⁸ doctrinalists who emphasize that the expectation remedy renders contract law less solicitous of promisees than tort law is of owners (there is no general tort doctrine of efficient conversion analogous to the contract doctrine of efficient breach),⁵⁹ and a small but perhaps growing number of courts who have suggested that a promisor who wrongfully breaches should be required to disgorge her gain under the restitutionary principle that a person should not profit from her wrong.⁶⁰

This association between the expectation remedy and a morally permissive account of promise-breaking is mistaken. That a promisor should be true to her words (and does wrong to break them) does not say what those words achieve: principles of fidelity are not principles of interpretation. The claim that the proceeds created by the rejection of an inefficient trade should

⁵⁶See, e.g., Douglas Laycock, *The Death of the Irreparable Injury Rule* 245-69 (1991); Daniel Friedmann, *The Efficient Breach Fallacy*, 1 *J. Legal Stud.* 1 (1989);

⁵⁷ See Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568 (2006).

⁵⁸ See, e.g., Daniel Friedmann, *The Efficient Breach Fallacy*, 18 *J. LEGAL STUD.* 1,2 (1989).

⁵⁹See, e.g., DOUGLAS LAYCOCK, *THE DEATH OF THE IRREPARABLE INJURY RULE* 245-64 (1991).

⁶⁰ *EarthInfo, Inc. v. Hydrosphere Resource Consultants, Inc.*, 900 P.2d 113, 119 (Colo. 1995).

be returned to the promisee in “restitution” of a wrongful gain is not an independent *argument* for restitution but rather expresses an interpretive *conclusion* about the content of the promisee’s expectations. Part 3 shows that the standard interpretive conclusion is incorrect. A promisee can share in the gains from rejecting trade either through the lower price that a contract that permits the promisor to exit on payment of the promisee’s trading gain requires or through the renegotiation that a promisee with a property right can force. In the typical case, the promisee’s expected return from contracting is maximized under contracts that make alternative promises. Promisees thus should be taken to have made such contracts unless the evidence proves otherwise. As a consequence, the default contract does not commit a promisor always to trade but rather to trade or to pay damages, an efficient breach is not a true breach, and a promisor who rejects trade is not profiting from a wrong. Seen in this light, the expectation remedy *is* specific performance of the promise to transfer that (as our model shows) contributes as significantly to surplus sharing as the promise to trade. The moral critique of contract damages has yet to refute this view.

4.3.1 The Dual Performance Hypothesis and the Wrong of Breach

There is a qualitative difference between a promisor who refuses to trade but voluntarily transfers, on the one hand, and a promisor who declines *both* to trade *and* to transfer on the other. The first promisor keeps her contract and honors her promissory obligation; the second breaches her contract and acts immorally. And when the expectation remedy is ordered by a court (as opposed to being volunteered by the promisor), then it is not just a price but a sanction – a form of redress for this wrong. Nor need it be the only form of redress. Nothing in our approach rules out that those who truly breach contracts – at least in appropriate cases – do not just come under a

duty to remedy their wrongs, but also deserve punishment.

Indeed, our reconstruction of the doctrinal order surrounding the expectation remedy opens this order up to the possibility of punitive damages for breach of contract. Far from encouraging breaches, the expectation remedy (properly understood) re-emphasizes the seriousness with which the law treats contractual promises – it is an integral part of the law’s commitment directly to enforce such promises (once the promises’ contents have been properly understood). Our argument therefore invites a new inquiry into the proper attitude for the law to take towards *true* breaches. That contract law takes these breaches seriously enough to remedy the wrong directly, by undoing it (by ensuring that one of the alternatives in the contractual promise to trade or to transfer is performed) makes it natural to ask whether the wrong merits legal punishment: whether punitive damages should be available for true breaches of contract, in which promisors refuse both to trade and to pay money.

The question whether punitive damages are appropriate in the case of true breaches is, on our view, therefore just the standard question which civil wrongs are sufficiently serious to warrant civil punishment. This is a difficult question even in tort (where the question of punitive damages is allowed to reach a jury only in the case of gross torts). It may be an especially difficult question in connection with breach of contract. Where freedom of contract reigns broadly (and can even set the operational boundaries of good faith and fair dealing), it is difficult to distinguish gross breaches of contract (for example, bad faith breaches) from breaches that violate only the contract itself.⁶¹ Moreover, mistakes in the direction of awarding punitive

⁶¹ This problem is not nearly so difficult in special substantive contexts, for example involving insurance contracts, where the regulated character of the business entails that much less of the arrangement between the parties belongs to

damages where none are deserved threaten both impermissibly to punish the innocent and to undermine the predictability of commercial litigation, thereby undoing many of the efficiency gains generated by expectation damages (including of course the gains associated with substituting transfers for inefficient trades that our model identifies). These concerns require courts to tread carefully. In many jurisdictions, courts decided that they cannot tread carefully enough and so in the end declined to venture forth at all. But if punitive damages for gross breach of contract have had a short career in American law,⁶² this is not because of any principled tension between their moralizing nature and the normative structure of the expectation remedy, but rather because of pragmatic difficulties that are internal to the effective articulation and administration of a punitive damages regime itself. Again, the expectation remedy – at least as a formal matter – allows contract law to say all the things concerning breach that moralists about promising wish it to be able to say.⁶³

4.3.2 Price versus Renegotiation Sharing

the contract and much more to the implied in law covenant, and where the strategic structure of the interaction makes conduct that constitutes bad faith on any terms more easily identifiable.

⁶²Experiments in awarding punitive damages for breach of contract, begun in the 1970s, were ended, and indeed reversed, by the 1990s. A 1998 survey reported that by then 39 American jurisdictions did not allow punitive damages in contract claims unless the plaintiff established an ordinary and independent tort and that only 12 jurisdictions allowed punitive damages in limited circumstances for tortious breach of contract. See William Dodge, *The Case for Punitive Damages in Contracts*, 48 *Duke L.J.* 629, 640-651 (1999).

⁶³Parties in the circumstances we consider prefer transfers in the amount of the promisee's expectation, not greater transfers. Hence, parties would reject contracts that give the promisee the power to reject the contractual transfer in

The moralist argument against the expectation remedy thus can succeed, if it succeeds at all, not on formal grounds but on *substantive* ones. There is no good substantive argument to make, however, unless contracts contain one promise – to trade – rather than two promises – to trade or to transfer. The substantive arguments implicit in prominent moral criticisms of the expectation remedy fail because they overlook this point.

An extravagant statement of the moral critique appears, for example, in Friedmann's polemical suggestion that the theory of efficient breach is, in principle, equally applicable in the property context, where it leads to the adoption of a theory of 'efficient theft' or 'efficient conversion.'⁶⁴ The analogy works only if a promisee's entitlement to a promise's action terms involves the same form of near-total dominion that characterizes an owner's entitlement concerning her chattels. But the typical promisee has waived the right to such dominance by accepting a contract that creates surplus sharing through the price mechanism.

The idea that the promisee has dominion over the promisor's actions plays an equally central role in the arguments of more modest and deliberate moral critics of the expectation remedy. Like its doctrinal predecessor, this idea exercises a hold over intuitions that draws commentators back in even as they try to shake loose of it. A recent example is Richard Brooks's proposal for replacing "efficient breach" with a remedial regime designed to ensure "efficient performance."⁶⁵

favor of collecting punitive damages. An argument to this effect is in Alan Schwartz, "The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures", 100 Yale L. J. 369 (1990).

⁶⁴Daniel Friedmann, The Efficient Breach Fallacy, 18 J. Legal Stud. 1, 4 (1989).

⁶⁵See Richard R.W. Brooks, The Efficient Performance Hypothesis, 116 Yale L.J. 568 (2006).

Brooks acknowledges “that both supporters and opponents of efficient breach seem to agree that promise-breaking is morally wrong. They just disagree about the nature of the promises made in contracts.”⁶⁶ But Brooks appears nevertheless to accept the moral critique of the expectation remedy. Thus he supposes that “it would be surprising if, for most people, contractual promises do not share some of the moral imperatives behind promises generally,”⁶⁷ and he assumes that these are imperatives to act rather than to act or to transfer, even going so far as to characterize the latter view (ours) as “morally permissive.”⁶⁸ Indeed, Brooks frames his discussion as an effort to construct a remedy that preserves the efficiency-properties of expectation damages but “is consistent with more robust notions of contractual duty” than those immanent in the expectation remedy; or, as he alternatively puts it, to construct a remedy that “can allow for optimal allocation of resources while achieving a higher degree of moral force than the intermediate level associated with efficient breach.”⁶⁹ In all of this, Brooks, like Friedmann, is concerned to prevent promisors from profiting from the moral wrong involved in substituting transfer for action: “What provokes disapproval of the efficient breach hypothesis,” Brooks says, “are strong moral sentiments that nonperformance of a contractual promise is not a right, but in fact is a wrong, and that promisors should not profit from unilateral exercise of their power to

⁶⁶Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568, 588 (2006).

⁶⁷Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568, 590 (2006).

⁶⁸ Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568, 590 (2006).

⁶⁹Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568, 573 (first quotation), 574 (second quotation) (2006).

perform or not.”⁷⁰

Brooks’s efficient performance hypothesis – because it is more carefully elaborated than Friedman’s accusations concerning “efficient theft” – helpfully illustrates the substantive intuition at the heart of the moral critique of the expectation remedy. In order to square contract remedies with assumed morality, Brooks would give a promisee the right to determine how a promisor conducts herself in respect of a contract’s action terms. Thus, he would make specific performance the standard remedy for breach of contract and allow a promisee who forgoes specific performance to force his promisor to disgorge any gains that the promisor’s rejection of trade created. Indeed, Brooks’s remedy must give the promisee not just an entitlement to the benefits of a promisor’s management of her actions but rather give the promisee an entitlement actually to control the promisor’s actions. This control includes forcing the promisor to “breach” and then to “disgorge” even when the promisor wishes to act (in our language, to transfer even when the promisor wishes to trade).⁷¹ Together, the two prongs of the efficient performance

⁷⁰ Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568, 572-73 (2006). Courts have in recent years increasingly made similar noises. As one prominent decision observes, at least where “the defendant’s wrongdoing is intentional or substantial,” the wrongdoer should not be allowed to retain the fruits of her wrong. *EarthInfo, Inc. v. Hydrosphere Resource Consultants, Inc.*, 900 P.2d 113, 119 (Colo. 1995).

⁷¹ Brooks’s text never makes clear whether he endorses this feature of his remedy-regime. He backs away from the suggestion at a critical juncture, recognizing that “it may seem a little odd to think of promisees forcing promisors to breach their promises and then making them pay for the breach (and, indeed, there is extensive case law discouraging the practice of induced breach).” Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568, 582 (2006). Moreover, he suggests in a footnote that his remedy does not, strictly speaking, give the promisee a pure option on his promisor’s performance but instead involves a “Dual Chooser Rule, whereby the promisor’s initial

remedy secure the promisee's dominion over his promisor's actions regarding the contract.

Brooks thus has constructed a mirror image of the expectation remedy which, like that more familiar remedy, requires a party to internalize the full social costs of his choice regarding how a contracted-for action is disposed of. (The expectation remedy makes promisors choose between the costs of action to themselves and the costs of non-action to their promisees; Brooks's remedy makes promisees choose between the costs of non-action to themselves and the (opportunity) costs of action to their promisors.) This is the central insight of Brooks's argument concerning economic efficiency.

It is unclear whether this argument applies to actual cases. A promisee who requires as much control over his promisor's actions as Brooks supposes is likely already to have bought the promisor.⁷² For the moment, however, we are more concerned with explaining that Brooks's

action (choice) can trigger the promisee's . . . option." Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568, 582 n.30 (2006). But Brooks, in the very next sentences, hedges his hedge and suggests that the idea of promisee choice is "not so strange." Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568, 582 (2006). In any event, the efficiency claims that form the core of Brooks's argument leave him structurally committed to the unfettered promisee choice that the main text analyzes. As Jody Kraus has pointed out, See Jody S. Kraus, *A Critique of the Efficient Performance Hypothesis*, 116 *Yale L.J. Pocket Part* 424 (2007), the symmetry between Brooks's remedy and the expectation remedy, and therefore the chooser-cost-internalization that is necessary for Brooks's claims concerning efficiency to get off the ground, will be achieved only if promisees may force promisors to "breach" and "disgorge" in the manner that we describe.

⁷²Recall that the parties that contract theory analyses often are firms. We briefly expand the text's point in the following way: Brooks's cost-internalization claim holds only if the promisee has a right to exercise total control over his promisor's conduct in respect of the contract's action terms. Brooks's remedy thus makes promisees into the managers – with full rights to exercise command and control – of their promisors' contractually promised actions.

remedy and the expectation remedy are *equally one-sided*: they equally imagine that control over contractual trade is vested unilaterally in a purely self-interested party; and they differ as to which party this should be. Brooks's remedy imports no more cooperation – no greater promissory solidarity – into the ex post contract relation than do expectation damages. Moreover, Brooks's unilateralism seems to us less attuned to the folk understandings of the promise relation than the opposite unilateralism associated with the expectation remedy. But in a way this is beside the present point, because whatever the facts concerning folk understandings turn out to be, it runs *counter* to the central place that freedom occupies in the morality of promising to insist – as Friedmann, Brooks, and other moralist critics of the expectation remedy do insist – that promissory morality *requires* that ex post control be allocated unilaterally to promisees even

Speaking loosely, under the regime Brooks proposes, promisees in effect become owners of their promisors' businesses in respect of a contract's action terms. This way of speaking invokes the Coasean theory of the firm, according to which the firm boundary – the boundary between coordination through ownership and managerial control and coordination by contract – is fixed by the balance between the transactions costs of each coordinating mechanism. *See generally*, RONALD COASE, *The Nature of the Firm*, in *THE FIRM, THE MARKET, AND THE LAW* 33, 44 (1988). But if the balance of these transactions costs really did make it efficient, as Brooks's remedy supposes, for promisees to exercise managerial control over their promisors' actions, those actions would already fall within the promisees' firms, so there would be no need for the contracts that Brooks's remedy seeks to vindicate. Put simply, where the allocation of discretion and control associated with Brooks's remedy really is efficient, there will be no separate legal entities to begin with and hence no contracts. The expectation remedy produces efficiency across the firm boundary, and Brooks's regime is, in effect, a re-description of efficient decision-making procedures within it. This argument puts in an industrial organization context our contract argument that parties commonly prefer to share through prices, which assume the existence of independent firms, rather than through property right renegotiations, which threaten to collapse firm boundaries.

where (in the pursuit of their joint interests) promisors and promisees have agreed otherwise.

And our model shows that the parties to ordinary commercial contracts – because of the way they share surplus in both the trade and transfer states – will typically reach just this agreement.

4.3.3 The Limits of Contractual Solidarity

These remarks concerning contractual solidarity lead to the final moral criticism of the expectation remedy that we consider. Unlike the arguments advanced by Friedmann and Brooks, which invoke moral intuitions concerning how to adjudicate the *competition* between promisors and promisees, this criticism invokes a moral ideal of promissory *solidarity*, according to which promises (and hence also contracts) achieve their moral value by replacing, or at least dampening, this competition in favor of a more cooperative contractual relation. On this account, the moral value of promises lies in the sharing of realized gains and losses that promises can involve. One of the basic, formal features of promising is that a promisor makes the promisee distinctive for her – she takes the promisee out of the general sea of humanity and becomes particularly attentive to the promisee’s person. As Joseph Raz observed, promises establish a special relationship between promisors and promisees, and the value of this special relationship plausibly explains why it is not a sufficient reason for breaking a promise that doing so is best overall.⁷³ Perhaps, then, the unilateralism associated with the expectation remedy wrongly eliminates such promissory solidarity, while other remedies (including, but not limited to, traditional specific performance) might better make room for it.

This moral position is implausible if the sharing that it contemplates occurs as sharing

⁷³See Joseph Raz, Promises and Obligations, in *Law, Morality, and Society: Essays in Honor of H.L.A. Hart* 210, 227-28 (P.M.S. Hacker and J. Raz, eds., 1977).

occurs in our model. There, parties to the standard contract predict what later sharing requires of them, and they adjust the price to reflect their expected shares. Parties to a property right contract share ex post, but not in a way that is more other-regarding or solidaristic than sharing through a price reduction: sharing ex post is the product of a competitive renegotiation among self-interested parties bound to each other in bilateral monopoly as a result of the contract they made.

But contractual sharing ex post may arise in another context also – in which the parties to a contract abandon, or at least constrain, self-interested behavior within the contractual relation and instead cooperate in pursuing a fair balance of their interests. This kind of ex post sharing, which we call *cooperative sharing*, is certainly known to contract law – it is displayed by joint venturers or other fiduciaries, for example, as in Cardozo’s famous remark that joint venturers owe one another “the punctilio of an honor.”⁷⁴ Moreover, there is a close connection between contract and cooperative sharing. In particular, at least among parties who begin their relations at arm’s length, cooperative sharing can be achieved *only* ex post, that is, within the solidaristic relation established by an exchange of (contractual) promises.

Cooperative sharing has an at best uncertain appeal for the efficiency-minded. To be sure, a legal regime that supports or even imposes cooperative sharing may serve efficiency in the narrow class of circumstances in which at least one of the parties cannot anticipate at the time of contracting what the optimal exchange will turn out to involve (and perhaps also cannot verify ex

⁷⁴Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 128).

post whether the other party has satisfied whatever standards the contract attempts to set).⁷⁵ But in the broader class of cases in which performance can be described in advance and is verifiable, cooperative sharing reduces the promisee's expected return and increases transaction costs. However, efficiency is not the only value, and at least some moralists about contract may be understood to propose another, broader, justification of cooperative sharing in contract, based on such sharing's *intrinsic* moral value. In its most general form, this moralism about contract claims that the morality of promise requires cooperative sharing in *all* promise relations, and that since all contracts contain promises, the morality of promise also requires the law to support, or at least not to undermine, cooperative sharing in contracts generally. On this view, the moral value of cooperative sharing outweighs the efficiency generated by the unilateralism of the expectation interest.

A moralism that insists on cooperative sharing in contract opposes the expectation remedy because the remedy undermines cooperative sharing, as indeed such sharing is equally (if oppositely) undermined by the remedy that Brooks prefers. Both remedies quarantine contractual sharing within the *ex ante* state and allow one party or the other unilaterally to pursue her own interests *ex post*. Indeed, both remedies achieve their efficiencies in part by carrying the competitive relationship that characterizes pre-contractual bargaining *into the interstices of the contract relation*. We therefore conclude our moral analysis of the expectation remedy by asking

⁷⁵Recall our epistemic assumptions. See *supra* at _____. One of us has proposed a related argument for the case of relationship-specific investments made in particular circumstances. See Alan Schwartz and Robert Scott, Precontractual Liability and Preliminary Agreements, 120 Harv. L. Rev. 661 (2007).

how this feature of the expectation remedy stands with respect to the morality of promising. Our procedure is first to demonstrate that an ideal of cooperative sharing is the source of certain moralist attacks on the expectation remedy and then to assess whether this ideal is appealing, at least in the context of commercial contracts.

The most sustained elaboration of this moral criticism of the expectation remedy appears in the work of Seana Shiffrin, who, in a recent article, identified the expectation remedy and the practice of “efficient breach” as one of several places at which contract law unappealingly departs from the morality of promising,⁷⁶ and who has now elaborated the nature of this departure in greater detail.⁷⁷ Cooperative sharing does not figure expressly in Shiffrin’s argument, however, and so it takes some interpretive work to show that this ideal is the foundation of her objection to the expectation remedy.

Shiffrin makes two claims concerning the expectation remedy, which together provide a point of entry to her argument’s deeper structure. First, she claims that when a promisor transfers rather than trades, the expectation remedy requires a promisee who prefers trade to realize trade himself, by converting the transferred funds. For example, a buyer whose seller rejects trade must make a substitute purchase.⁷⁸ Second, Shiffrin observes that conventional contract doctrine imposes on the promisee a *legal obligation* to act on his promisor’s behalf, in the sense that the promisee must arrange a substitute at least cost to the promisor. In the language of the doctrine,

⁷⁶ See Seana Shiffrin, *The Divergence of Contract and Promise*, 120 Harv. L. Rev. 708, 727 (2007).

⁷⁷ See Seana Shiffrin, *Could Breach of Contract be Immoral?*, 107 Mich. L. Rev. 1551 (2009).

⁷⁸ See Shanna Shiffrin, *“Could Breach of Contract be Immoral”*, 107 Mich. L. Rev. 1551, 1564 (2009).

the promisee must mitigate the promisor's damages.⁷⁹ Shiffrin is hostile to both aspects of the doctrine. In her view, the disappointed promisee has been betrayed. Forcing him to reenter the market, and in a manner that weighs the promisor's interests as equal to his own, adds insult to injury.

Shiffrin's claim that the doctrine insults a disappointed promisee is important. To be sure, Shiffrin also objects to the doctrine because the duty it creates may be costly for the promisee to satisfy. For example, she worries about the serious inconvenience a homeowner incurs when a plumber refuses to repair.⁸⁰ Her distaste for mitigation cannot rest on the existence of such costs, however. Mitigation requirements are structured so that a buyer who mitigates is supposed to be at least as well off as performance would have left him: even though mitigation may require buyers initially to bear some costs, these costs are in principle compensable as incidental damages. In the real world, of course, some mitigation costs – emotional upset, hours spent finding another contract partner – may go uncompensated. But that is a defect in the law rather than its purpose, and Shiffrin's objection is to the law itself. Hence, she claims, the objection

⁷⁹Id. This requirement also may be expressed in causation terms. The promisor's failure to trade creates an expectation loss for the promisee. Any damage increment above this loss that a cost-justified promisee action could have prevented is attributable to the promisee. As an example of the law's causation language, a buyer may recover "any loss ... which could not reasonably be prevented by cover or otherwise". UCC §2-715(2)(a). A promisee's limited right to recover can be justified on either causation or mitigation grounds because both grounds rest on the same premise, that the promisor is obligated to pay the expectation but is not obligated to trade. The promisee thus causes any loss above the expectation, and must achieve trade on his own.

⁸⁰ Id. at 1564.

would hold even in a fantasy world in which to mitigate would cost promisees nothing.⁸¹

Insult thus is the gravamen of her critique. It is the case, in the fantasy world as well as ours, that a promisor who rejects trade has unilaterally allocated to the promisee the task of securing a substitute performance. Shiffrin adds, though admitting that this way of speaking exaggerates the point, that the promisor has made the promisee her “involuntary employee.” As Shiffrin says, “[s]he has usurped [his] ability to make independent, voluntary decisions about the use and form of [his] time, attention, and labor.” And this usurpation, when done to a free and rational person, is an insult.⁸²

It is incorrect to claim that promisees are insulted, however. Shiffrin’s argument presupposes what we deny: that the typical contract requires the promisor only to trade, so that her failure to trade is a breach whose consequences the promisee must mitigate. Rather, we show that the promisee’s payoff, in the critics’ ideal world, is invariant to whether the contract requires trade or whether the contract permits the promisor to choose whether to trade or to transfer. In

⁸¹ Seana Shiffrin, *Could Breach of Contract be Immoral?*, 107 Mich. L. Rev. 1551, 1564 (2009). We do not deny that this is a fantasy or that the expectation remedy and mitigation requirement, as administered, sometimes are undercompensatory. We devote these pages to defending what the critics (Shiffrin included) attack, namely the idealized, fully compensatory expectation remedy.

⁸²Id. See also, Seana Shiffrin, “The Divergence of Contract and Promise”, 120 Harv. L. Rev. 708, 727 (2007). Shiffrin uses the example of a homeowner and a plumber to make these points. This example is significant. A natural person who is a promisor may insult a natural person who is a promisee, but it may be a category mistake to claim that Corporation A “insults” Corporation B by refusing to trade. Shiffrin criticizes the mitigation requirement as it applies everywhere, but it takes, we think, a theory of “corporate insult” to show that the criticism applies in

more realistic scenarios, the promisee's return is higher under the latter, standard, contract.⁸³ An additional reason for this preference, not set out above, exists when the promisee can procure a substitute more cheaply than the promisor. In these common cases, the price is lower when the promisor is permitted to reject trade because the price reflects the promisor's costs. A legal regime in which a promisee must mitigate therefore does not impose any involuntary obligation on the promisee; rather, it makes him the beneficiary of an efficient contract whose terms he chose. (He is the beneficiary because, recall, the gains associated with mitigation are shared through the contract price.) A buyer who purchases under the standard contract is therefore not rendered the promisor's employee but rather, as it were, mitigates on his own account. The mitigation requirement thus not only advances the promisee's interests; it is an expression of his freedom.

But Shiffrin (unlike Friedmann and Brooks) identifies another ground for insisting that promisors are obligated specifically to act, a ground that sounds in the character of the contract relation. This comes out later in her argument, when she remarks on an apparent asymmetry between the parties' positions before and after they contract. A promisee cannot force his

commercial contexts. No such theory exists. The text above, however, meets her argument on the general terms in which it is expressed.

⁸³Shiffrin also criticizes the mitigation requirement because promisees, in her view, desire for themselves the goods and services that constitute trade rather than (as the mitigation requirement supposes) view trade as a way-station on the road to further economic advantage. See 107 Michigan L. Rev. at 1565. This claim too seems out of place in the typical commercial exchange. A business buyer does not want goods or services simpliciter; he wants the gain that trade in goods or services yield. It follows that he prefers the contract that maximizes his expected gain to the lower value contract that requires trade always.

promisor to enter into a contract by offering to pay the price of the contract's action terms (a buyer may not force someone to sell by offering to pay the good's market price). Once a contract is made, however, the promisor can force her promisee to replace her action with someone else's (at least where cover is efficient, a seller may force her buyer to cover).⁸⁴ It is at least "peculiar,"⁸⁵ Shiffrin says, that a promisor enjoys greater protection against involuntary interference from her promisee without the contract relation than her promisee enjoys against involuntary interference from her within it. "[T]here is no clear reason why after the relationship is formed, [the] nonconsensual behavior [involved in a promisor's unilateral decision to transfer rather than to trade] should be more morally anodyne than it would have been ex ante."⁸⁶ Indeed, Shiffrin suggests, such behavior is simply wrong.

There is a "clear reason", however, which is that the promisor's actions are consensual. Under what we have called the standard contract, the promisee agrees, in return for a price reduction, to permit the promisor later to choose between trade and transfer. The promisor's "unilateral decision" thus is no more unilateral than is the decision of any agent whose principle instructs her to choose between two permitted acts. We shall give this explanation of the parties' preferences a moral interpretation in a moment.⁸⁷

⁸⁴This is not quite literally so: A seller cannot *require* her buyer to cover but only to choose between covering and not getting the good at all.

⁸⁵Seana Shiffrin, *Could Breach of Contract be Immoral?*, 107 Mich. L. Rev. 1551, 1566 (forthcoming 2009)

⁸⁶Seana Shiffrin, *Could Breach of Contract be Immoral?*, 107 Mich. L. Rev. 1551, 1566 (forthcoming 2009)

⁸⁷ Shiffrin raises a final economic argument against understanding contracts, as we do, to involve promises to trade or to transfer. She observes that promisees typically enter into contracts because they are interested in receiving the specific goods or services that the contracts' promises specify rather than the generic value of these

But first we observe that Shiffrin's concern is justifiable on a different view of the contract relation. According to this view, entering into a contract changes the relationship between contracting parties, so that even where they have *approached* each other at arm's length, the contract makes their relation *within it* closer than arm's length. The parties' duties under a contract thus cannot be measured by the contract alone.⁸⁸ Instead, parties have an open-ended duty to cooperate. This duty requires each party to respect the interests and motives that led the other to enter into the contract and to adjust to new facts and circumstances in a way that is other-regarding in respect of these motives and interests. Shiffrin reasons from the existence of this

goods or services, as reflected in the contracts' transfer terms. Seana Shiffrin, *Could Breach of Contract be Immoral?*, 107 Mich. L. Rev. 1551, 1565 (forthcoming 2009). She then invites one to "[c]onsider the absurd result in such cases if the payment of expectation damages were the universalized, reflexive response to agreements. No promisee would ever get what she sought. As a further consequence, if this were the universalized response, then agreements would never be made." *Id.* This argument apparently assumes that a seller who has the right either to trade or to pay will always choose pay. Part 3.1 above shows, in contrast, that the seller chooses pay only when trade would produce a larger loss. Since giving the seller the ability to minimize ex post losses maximizes the buyer's expected return, there is *more trade* under the expectation interest remedy than there would be under Shiffrin's proposed remedial scheme.

⁸⁸Here it is worth noting a contrast between such an open-ended duty to cooperate and the mandatory duty of good faith in performance that contract law imposes. The content of the duty of good faith is limited by the content of the parties' promises: good faith forbids each party from exploiting vulnerabilities that arise over the course of a contract relationship in ways that prevent the other from realizing the benefits that the contract confers. Good faith is thus a duty that exists only at arm's length – a duty not to exploit subsequent events in ways that undermine the division of surplus that the initial arm's length agreement fixed. Unlike cooperative sharing, good faith does not involve any

duty to the conclusion that while a promisor may refuse to make a contract, though the potential promisee offers a fair price, the promisor cannot both contract and keep the promisee at arm's length regarding performance. To be precise, when contract law authorizes the promisor to choose ex post between transfer and trade, depending on which maximizes her utility, the law thus undermines the cooperative sharing that constitutes the moral essence of the promissory relation, and hence also of contract. Shiffrin's view that a promisor who transfers rather than trades drafts her promisee into her service in the same way that a promisee would do if he could force the promisor to contract by offering the market price thus is explicable only on the assumption that contracts typically replace arm's length sharing ex ante with cooperative sharing ex post.

This analysis explains Shiffrin's view but does not justify it. Commercial parties, we show, *prefer* to let the promisor choose between trade and transfer. Hence, Shiffrin's view commits her to the claim that contract law should override the parties' preferences in order to force them to be good. To understand why Shiffrin is committed to paternalism, consider the cases in which the law applies a cooperative model of ex post sharing within promissory or contractual relations: marriage and, more generally, joint ventures.⁸⁹ Sharing in these

open-ended obligation to attend to the motives and interests of the other party in ways that extend beyond the division of surplus agreed to in arm's length sharing, ex ante. See generally UCC §1-304.

⁸⁹ Thus courts commonly observe that “[j]oint venturers, like partners in a partnership, owe a fiduciary duty to one another.” *Miami Subs. Corp. v. Murray Family Trust*, 703 A.2d 1366, 1373-74 (N.H. 1997). See also, e.g., *Electronic Associates, Inc. v. Automatic Equipment Development Corp.*, 440 A.2d 249, 251 (Conn., 1981) (“As a matter of law, parties to joint ventures undertake fiduciary duties to each other concerning matters within the scope of the joint venture.”) (citing *Sime v. Malouf*, 95 Cal.App.2d 82, 98, 212 P.2d 946 (1950)); *Lucas v. Abbott*, 198 Colo.

relationships cannot be cabined by the terms of the agreements that establish them: a fact that is self-consciously announced by the language of the marriage vow – “for better or for worse” – and by the duty of fiduciary fidelity that joint venturers owe to each other. Sharing is not cabined contractually because these relationships involve the adoption of a shared project: a family, in the case of marriage; and a business enterprise, in the case of a joint venture. The parties to such contracts agree to pursue the projects (at least in some measure) apart from the contributions that the projects make to their individual interests: as measured by these interests, the parties, sometimes literally, agree to pursue their projects for better or for worse. And in these cases something like Shiffrin’s analysis of breach applies. A promisor who transferred rather than traded would betray the joint venture’s shared project in favor of the antecedent purely personal interests that the project was intended to replace, and vindicating her promisee’s expectation interest would similarly measure the value that she placed on performance in a metric that the initial contract agreed to abandon. But note that the betrayal is of the relation that the parties ex ante agreed to establish. The law requires cooperative behavior ex post to implement the parties’ ex ante preference for a sharing regime. And most parties, in most circumstances, do not prefer

477, 601 P.2d 1376 (1979)). The marriage relation establishes analogous duties among the partners. Thus “[c]ourts simply should not countenance either party to such a unique human relationship [i.e., marriage], dealing with each other at arm’s length. We have recognized, furthermore, in the context of an action based upon fraud, that the special relationship between fiduciary and beneficiary compels full disclosure by the fiduciary. Although marital parties are not necessarily in the relationship of fiduciary to beneficiary, we believe that no less disclosure is required of such parties when they come to a court seeking to terminate their marriage.” *Billington v. Billington*, 220 Conn. 212 (Conn. 1991).

this regime.

Thus, even purely personal promises seem intuitively often to involve only ex ante sharing cabined by the terms of an agreement rather than cooperative sharing ex post. Suppose, for example, that a sports-lover promises to treat her opera-loving friend to a performance of *Pelléas et Mélisande*, and that when she goes to buy the tickets she learns that only unexpectedly expensive seats remain available and therefore decides not to give the treat. What ought she now to do? To be sure, she cannot vindicate her promise by giving her friend a cash payment equal to the value that he ascribes to seeing the opera. But the reason why the ordinary morality of promising balks at such cash payments is not necessarily that it rejects the idea of equivalent performance, *tout court*, but only that introducing money payments into personal relations has commodifying and alienating effects, and hence is generally taboo.⁹⁰ Moreover, suppose that the promisor discovers that *Rodrigue et Chimène* is playing across town, that ordinarily-priced seats remain available there, and that her friend loves both operas equally. If she unilaterally substitutes the second opera for the first, has she committed a wrong, or indeed even broken her promise?

We think that, save in unusual circumstances, she has not. An arrangement of this sort is best understood as a promise to give her friend a treat of a certain (rough) cost and value. As it turned out, delivery of the treat that the promise expressly named – the analog of trade – was

⁹⁰ The same effect may readily be seen in a tort-like context, for example, when a dinner guest breaks one of his host's wine glasses. Although the guest clearly has a duty of redress, paying the host the cash value of the glass will not satisfy it (and may even make matters worse). Moreover, although the guest might satisfy my duty by giving the host

unexpectedly, and inefficiently, expensive, and so the promisor substituted an alternative performance – the analog of transfer – that made her friend whole and cost her less. That there is no breach may be seen intuitively by observing that, although the promisor might in this case owe her friend an *explanation* for the change, she would not, once the explanation had been given, owe any further *apology*. Indeed, if the friend sought to extract an apology then he, and not she, would conventionally be thought to be violating the norms implicit in their relationship. Things might be different if the friends were both opera-buffs whose promises established the shared project of finally seeing *Pelléas et Mélisande*, as the personal equivalent of a joint venture. In this case, the friends have made a commitment to seeing that particular opera as a non-instrumentally valued shared goal, and so the first friend might be unable to acquit herself of her part in the plan by substituting another opera of equivalent instrumental value. But most personal promises, we think, are more like the original case than the modification. They are viewed by parties to them as instruments useful in pursuing antecedent and independent purposes, and they may therefore be honored by means alternative to those that they expressly name.

In any event, this instrumental account better captures the character of commercial promises – and hence of contracts – than the non-instrumental alternative associated with the joint venture model. The parties to contracts typically view each other and the trades that their contracts’ action-terms describe as instrumental (and hence in principle interchangeable) means in the pursuit of commercial ends that pre-date, and are not altered by, the commitments that the

a replacement glass, he might also (and indeed better) make redress by providing some alternative (and roughly equivalent) gift, for example of a bunch of flowers or a box of chocolates.

contracts establish. This is as it should be.⁹¹ Contract law's moral (and not just economic) purpose is to enable coordination on neutral terms in an open and pluralist economic and political order. In this order, contracts may arise between parties on either side of every economic and political dispute. And contract law can be open in this way only if parties can contract without ceding control over their larger purposes – that is, without committing themselves to cooperative sharing ex post in service of non-instrumental values. Turning to contract law's connection to liberty rather than to neutrality, a legal order that insists on cooperative sharing ex post is inconsistent with freedom of contract. This order would convert the contract relation into a kind of organic community, almost a status order, that parties may avoid altogether but cannot freely contour and constrain.

The tension between the modes of sharing associated with ordinary contract and cooperative sharing is greater still. To see why, observe that the mode of sharing involved in promise and, a fortiori, contract is incompatible with there being a *total identification* between the parties – this is just a way of characterizing the familiar thought that to make a promise to oneself is impossible. Moreover (although this will likely be a more controversial claim), promissory and contractual sharing are also difficult to establish among parties who, although not totally self-

⁹¹One of us has previously argued that contracts establish a certain form of joint activity among the parties to them, that this activity is characterized by sharing the end of achieving the contractual performance, and that this sharing underwrites the contract relations' moral worth. See Daniel Markovits, *Contract and Collaboration*, 113 *Yale L.J.* 1417 (2004). But the kind of sharing described there remains quite different from the ex post cooperation associated with a view like Shiffrin's. It is confined *within* the contract, and has its content fixed by the terms of the contract, and it is therefore much thinner than cooperative sharing (a point emphasized by calling such sharing collaboration and expressly rejecting the idea that it involves cooperation, see *Id.* at 1457).

identical, nevertheless posses *very close* antecedent connections. In the personal realm, for example, it is difficult to make effective promises within fully companionate marriages, because both partners' commitments to maximizing their joint outcome (viewed as a non-instrumental value) mean that any promissory rights that might arise between them will dissolve when this is no longer, from the point of view of the couple, best overall.⁹² And even in the commercial realm, there exist limits on freedom of contract within fiduciary relationships,⁹³ because the self-interest that lies at the core of contractual sharing is incompatible with the cooperative attitudes required by the fiduciary form. Cooperative sharing, on Shiffrin's model, therefore does not just present an alternative to the thinner forms of solidarity associated with contractual sharing as we understand it; rather, where it arises or is imposed, cooperative sharing makes contractual solidarity impossible. Shiffrin's model is therefore strictly speaking *incompatible* with the forms of sharing associated with contract.

⁹² One of us elaborates this idea in greater detail in Daniel Markovits, *Promise as an Arm's Length Relation*, in H. Scheinman, ed., *Understanding Promises and Agreements: Philosophical Essays* (forthcoming 2010).

⁹³For example, a lawyer may not represent a client if the representation involves "the assertion of a claim against another client represented by the lawyer in the same litigation or other proceeding before a tribunal," Model Rules of Prof'l Conduct Rule 1.7(b)(3), or, more generally, if she cannot "provide competent and diligent representation to each affected client." Model Rules of Prof'l Conduct Rule 1.7(b)(1). See also Restatement of the Law Governing Lawyers s. 122(2)(a). In each case, it does not matter if the client knowingly agrees to the representation nevertheless. Freedom of contract does not penetrate the fiduciary lawyer-client relation, and the conflicts are, in the language of the law of lawyering, non-consentable.

The ex ante sharing associated with the expectation remedy and the view that contracts involve promises to trade or to transfer therefore better match not just the economic but also the moral purposes of contract than does Shiffrin's alternative. For these reasons, we reject cooperative sharing ex post as the right model of the contract relation. Instead, the substantive values associated with promissory morality, when applied to the special case of contractual promises, favor arm's length, ex ante sharing. Moreover, our economic model reveals that parties who engage in arm's length sharing produce agreements that do not fetishize trade over transfer but rather permit promisors to honor their promises by performing the promises' transfer terms. This is a case in which the morality of promising aligns with the economics of contract. These reflections suggest that in addition to being formally consistent with taking a moralistic view of contract law, the expectation remedy (properly understood as an interpretive presumption) is also consistent with promissory morality's substantive ideals, at least when these are applied to the ordinary circumstances of commercial contracting.

V. Conclusion

We defend the expectation remedy, as it is conventionally applied in contract law, against recent attacks that argue in favor of replacing this remedy with a legal regime that gives the promisee a property right in his promisor's performance. The new regime would accord the promisee a routine right to specific performance, or to disgorgement of the promisor's gain if specific performance is infeasible. Promisees, we show, do have a property right, but the critics mistake the right that promisees have.

The typical contract contains three sets of terms: (i) “action terms” that describe the performance the promisor is to render; (ii) a “transfer term” that describes the payment the promisor must make if she does not perform the action terms; and (iii) a price, which describes the payment that the promisee must make if the promisor performs the action terms. The critics claim that the promisee has a property right in the action terms: that is, to the trade the promisor agreed to make. It follows that the promisee is entitled to specific performance. The critics, however, are generally committed to the view that parties can make whatever contract they wish. We show here that, if party sovereignty is the touchstone, the promisee has a right only in the transfer term, and then only if the promisor fails to perform the action terms. Two results follow from this showing. First, a promisor’s refusal to perform a contract’s action terms is not a breach; rather, a breach occurs when the promisor rejects trade under the contract’s action terms *and* rejects payment under the contract’s transfer term. Second, an action to enforce a contract’s transfer term – i.e., a suit to recover the promisee’s expectation – actually *is* an action for specific performance, because the suit enforces the promisee’s right to the contractual transfer.

We sustain these results by validating what we call “the dual performance hypothesis”. Our critics implicitly presuppose that parties to contracts are rational, self interested, sophisticated, and well informed about the relevant economic variables; and that courts are well enough informed to enforce a promisee’s expectation. On these assumptions, we show, contracts are best interpreted to permit a promisor either to trade under the contract’s action terms or to remit to the promisee the transfer that the contract requires. This transfer, in turn, is in the amount of the gain that the promisee would have realized had trade occurred: the transfer, that is, is the

promisee's expectation. The dual performance hypothesis holds that contracts commonly take this form.

Our validation of the hypothesis rests on four grounds: (i) Under the conditions the critics assume, a promisee's expected gross payoff under a contract does not vary with the remedy he has. The specific performance remedy gives the promisee the power to capture a share of the gain the promisor makes by rejecting trade; markets give the promisee who is entitled only to his expectation the power to capture the same share of the gain through the vehicle of a lower price. (ii) A promisee's expected net payoff often is higher under a contract that protects his expectation because the transaction costs accompanying the writing and enforcement of this contract are lower than the transaction costs that would accompany a property right contract. (iii) Were both contract types enforceable, the expectation interest remedy would be a good default when courts are sufficiently well informed to protect the expectation; parties would accept the default because contracts that protect the expectation commonly are maximizing relative to contracts that create property rights. (iv) A promisee's consent to the expectation interest default would be actual rather than hypothetical. The price of a contract is a joint function of the cost of the action terms and the size of the transfer term. Sophisticated parties pay attention to what deals buy them, and thus pay attention to both components of the price.⁹⁴

⁹⁴Another way to put this point is that parties today attempt to contract away from the expectation remedy only when courts lack the information to protect the expectation, or could get that information only at prohibitive cost to the parties. This contracting behavior is consistent with our claim that parties understand the value of the expectation remedy.

These grounds support our claim that the expectation remedy is analytically consistent with the immanent normative structure of contract. The expectation remedy is also formally consistent with taking a moralistic approach to contract law, according to which true breaches of contract are wrongs that can qualify for punitive damages. On our view, recall, a true breach is the promisor's rejection of both trade and transfer. Additionally, we argue that the ex ante sharing associated with the expectation remedy best captures the substantive ideals behind promissory morality, at least as these ideals are worked out for the case of promises among strangers in open, pluralist economic and political orders. Together, these arguments renew the overall case for making expectation damages the standard remedy for breach of contract.

Our broader argument is best understood as pursuing a representation result – that is, it is an effort to lay bare the formal structure of the contract relation.⁹⁵ We have shown that a certain set of economic, philosophical, and legal ideas can represent a particular legal practice. More specifically, we demonstrate that the substitutionary account of the expectation remedy (which is implicit in both the efficient breach hypothesis and the writings of those who criticize efficient breach) is merely epiphenomenal, and, moreover, misleading. We explain the expectation remedy more accurately without including any substitutionary remedy in the explanation, instead treating every contract remedy as formally an instance of specific performance and allowing the content of the obligation that is being specifically enforced to vary, according to the dual performance hypothesis.

This representation result matters for legal practice – for the development of doctrine and the outcomes in concrete cases. The criticisms of the expectation remedy that we seek to debunk

⁹⁵ We thank John Mikhail and Henry Smith for pressing us helpfully on this point.

may be understood, at a general and abstract level, as asserting that the substitutionary account of the expectation remedy implicit in the theory of efficient breach is inconsistent with the formal structures of contract and promise that law and morality establish. Insofar as courts and other lawmakers accept these criticisms, they will be tempted (as in the Restatement (Third) of Restitution and in *EarthInfo*) to award disappointed promisees supracompensatory remedies, on the model of disgorgement. Our argument, however, demonstrates that to do this is wrong: the actual formal structure of contract and promise – which makes specific performance (formally understood) the only remedy for breach – is sufficiently capacious to support the efficient outcomes that the theory of efficient breach recommends. We therefore affirm the still-conventional account of the positive law against its revisionist critics.⁹⁶

We acknowledge that we defend the conventional wisdom by *characterizing* the law in an unconventional way. Thus, both conventional champions and critics of the expectation remedy think of the remedy as introducing substitutionary relief into the law of contracts to sit, more or less comfortably, along-side the direct relief associated with specific performance.⁹⁷ Our approach, by contrast, seeks to understand the expectation remedy without the confusion of trying to combine direct with substitutionary relief in a single doctrinal order. In this respect, we acknowledge, we are making an unfamiliar proposal. We believe that our economic and philosophical arguments are sufficiently strong to warrant adopting our characterization of the

⁹⁶For example, Restatement (Second) of the Law of Contracts § 344.

⁹⁷The law takes this line, for example, when it characterizes even liquidated damages (and, *a fortiori*, expectation damages) as merely substitutionary. See Restatement (Second) of the Law of Contracts § 361 cmt.[a]. Critics of the

law. And we observe, moreover, that the critics of the expectation remedy also proceed, principally, on the planes of economics and philosophy rather than doctrine.⁹⁸

Finally, we think it possible to argue that our approach to contract remedies, and in particular our emphasis on direct rather than substitutionary relief, actually does best account for the positive law: the Restatement's and the Uniform Commercial Code's cumulative remedy rules and also the law's treatment of liquidated damages, remedy limitations, and specific performance (understood in the conventional sense of directly enforcing a promise to trade). In particular, our approach improves on more conventional doctrinal accounts by distinguishing, as these accounts do not, between cases in which the parties disagree shallowly, about the promisee's valuation of trade, and those in which they disagree more deeply, about the promisor's obligation to vindicate this value *tout court*. By emphasizing this distinction, our approach introduces an additional dimension into doctrinal analysis, which enables us neatly to organize rules and outcomes that

expectation remedy adopt the same characterization when they treat "efficient breach," even coupled with the payment of money damages, as truly a *breach*.

⁹⁸ In the tradition in which we write, the positive law – in the form of particular and elaborate doctrinal detail – has been absent from the debate over expectation damages. Other traditions have taken doctrine in this area more seriously. The leading doctrinalist critics of the expectation remedy and the theory of efficient breach in the United States are probably Douglas Laycock and Mark Gergen. See, e.g., Douglas Laycock, *The Death of the Irreparable Injury Rule* (1991); Mark Gergen, "The Law's Response to Exit and Loyalty in Contract Disputes," in *Comparative Remedies for Breach of Contract* (2005) and *A Theory of Self-Help Remedies in Contract* (unpublished manuscript on file with the authors).

otherwise appear unprincipled and *ad hoc*. Of course, these are assertions only, which must be vindicated, if at all, on another occasion.⁹⁹

Our representation result also matters for legal theory. Although it is up to the parties to establish the content of their respective rights and obligations under their contracts, it cannot be up to them to establish the form *contractual obligation* within which this content is fixed. This form is a matter for contract *law* and, perhaps, ultimately, for morality rather than for any particular contractual promise – indeed, the existence of the form is a transcendental condition of the legal and moral force of the particular promises that arise under it. The law must be involved because individual promisors lack the normative power to establish a form of obligation, either legal or even moral, merely by pronouncing that they are under it.¹⁰⁰ Similarly, they lack the capacity to change the normative consequences that follow from breach of an obligation.¹⁰¹

⁹⁹One of us is attempting the doctrinal argument. See Daniel Markovits, “The Doctrinal Foundations of the Dual Performance Hypothesis and the True Meaning of Efficient Breach” (working paper).

¹⁰⁰Indeed, it is commonly worried, for example by Hume, that individual promisors lack the normative power to create particular obligations simply by promising. This worry led Hume to compare the idea that the act of will involved in promise-making in itself begets a duty of promise-keeping to the mystery of transubstantiation. See DAVID HUME, *Of Morals, in A TREATISE OF HUMAN NATURE* Bk. III, Pt. 2, Ch. v, at 455, 524 (2d ed., Oxford Univ. Press 1978) (1888). The power to create particular obligations is surely less troubling than the power to create an entire moral form. For more recent discussions of the problem of the will’s normative power see, e.g., Michael Pratt, “Promises, Contracts, and Voluntary Obligation”s, 26 *Law & Philosophy* 531 (2007); Daniel Markovits, “Contract and Collaboration”, 113 *Yale L.J.* 1417, 1442-43 (2004); Joseph Raz, “Voluntary Obligations and Normative Powers”, 46 *Aristotelian Soc’y* 79, 99 (Supp. Vol. 1972).

¹⁰¹A promisee can forgive a breach or release the breaching promisor from her remedial obligations. But she cannot make it that the breaching promisor has not done wrong or that she is not subject to a remedial obligation.

Courts have understood this. One example, from a case made famous for another reason, appears (explicitly although also a little cryptically) in the dissent in *Groves v. John Wunder, Co.*, when the dissenters say:

“[T]he obligation of the contract does not inhere or subsist in the agreement itself ... but in ... the act of the law in binding the promisor to perform his promise. . . . A contract is not a law, nor does it make law. It is the agreement plus the law that makes the ordinary contract an enforceable obligation.”¹⁰²

Our representation result reveals that the doctrinal elaboration of contract remedies – and in particular the default preference for “expectation damages” and secondary recognition of “specific performance” – is consistent with these theoretical limits on contracting parties’ normative powers.

Finally, although our argument focuses on the merits, we conclude with a methodological observation. Economic and philosophical approaches to private law generally tend to display opposite strengths and weaknesses: economic approaches capture the law’s instrumental appeal, but they tend to neglect the law’s formal existence as a structure of rules and meaning and hence risk presenting an unappealingly reductionist picture of law, overall; philosophical approaches, by contrast, capture the law’s rule based structure and its immanent meanings, but they tend to neglect that law is also an important tool for serving extra-legal ends and hence risk presenting an unappealingly unworldly picture of law. Our argument aspires to exploit the strengths of both approaches while avoiding the weaknesses of each. Thus, although we begin with an economic model that is driven by the law’s instrumental properties, we elaborate the model with an eye to

¹⁰²*Groves v. John Wunder, Co.* 286 N.W. 235, 239-240 (Minn. 1939)

characterizing the law's instrumental properties in terms – specifically concerning the immanent structure of contractual surplus-sharing – that invite non-instrumental interpretation. Then, when we take up philosophical ideas concerning the formal structure and moral meanings of legal rules, we apply philosophy's reconstructive techniques to a set of doctrinal understandings arrived at with the law's instrumental powers and purposes in mind. These features of our argument emphasize the appeal that interdisciplinary work holds: the possibility that when several disciplines engage one another, each will help the others to avoid certain characteristic failings, so that the whole of the interdisciplinary argument is greater than the sum of its more conventional parts.

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