

Essay

The Evolution of Contract Remedies (or, why does Trebilcock teach remedies first?)

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I. Introduction

Much of contract law scholarship can be divided between the study of default provisions and of mandatory rules. Mandatory rules of contract formation and enforcement were the principal focus of *The Limits of Freedom of Contract* (hereafter *Limits*),¹ as Michael Trebilcock evaluated them through the lenses of social welfare maximization and the moral grounds of personal autonomy. The book also provides a valuable framework for the design of default provisions for commercial transactions, where parties are imperfectly informed, but knowingly so. Trebilcock is most likely to find an alignment between the autonomy and welfare theories of contract enforcement in the world of commerce. Efficient default provisions, based on hypothetical consent, promote autonomy by lowering the cost of promising.² Yet, as he has done in other work, Trebilcock demonstrates that efficiency calculus of defaults is highly context dependent and often complicated.

In *The Role of Insurance Considerations in the Choice of Efficient Civil Liability Rules*,³ Trebilcock explains that optimal risk allocation depends on factors – precautions, information, and risk-spreading ability – that each favor different parties and therefore must be weighed to

¹Michael J. Trebilcock, *The Limits of Freedom of Contract* (1993).

²See also Steven Shavell, *Is Breach of Contract Immoral*, 56 Emory L.J. 439 (2006) (arguing that breach of contract – and payment of damages – is not immoral because it reflects the parties hypothetical bargain), Jody Kraus, *The Correspondence of Contract and Promise*, 109 Colum. L. Rev. (forthcoming 2009) (arguing that “[m]ajoritarian default rules maximize the probability that the terms to which promisors are being held correspond with the ones they intended but failed to express or imply, and they save the majority of individuals the costs of specifying those terms, which respects their personal sovereignty by decreasing the barriers to creating promissory obligations.”) [at p27 of draft]

³Michael J. Trebilcock, *The Role of Insurance Considerations in the Choice of Efficient Civil Liability Rules*, 4 J. Law, Econ. & Organ. 243 (1988).

determine the efficient risk bearer in aggregate. In chapter 6 of *Limits*, he appropriately criticizes Posner and Rosenfield's risk-bearing justification for the doctrines of frustration, impracticability and impossibility.⁴ Trebilcock questions whether, as a descriptive matter, the case law supports their theory and, as a normative question, the doctrines are well suited to serve the function of ex-post risk allocation.

*The Law of Contract Modification: The Uncertain Quest for a Bench Mark of Enforceability*⁵ is also a foundational contribution to the study of contract law. This article demonstrates that, even if renegotiation permits parties to achieve ex post efficiency after conditions have changed, the modification disrupts the contractual allocation of risk and undermines the promisor's incentives to take precautions and insure against the risk. This was one of the first scholarly articles to identify the tension between ex post and ex ante efficiency that has become central to contract theory. As noted later in this essay, much of the concern in the law-and-economics of contracts had focused on efficient performance (or breach). Along with several other scholars, Trebilcock helped bring contracts scholarship up to speed with torts analysis by broadening the analysis to include various other incentive and risk-bearing objectives – thereby making the default rule project all the more challenging. In designing a contract or default rules, one may need to take into account risk preferences, ability to insure, incentives to gather or disclose information, the decision to contract, incentives to take precautions and to rely on the contract, and so on.

These observations might dampen one's hope of designing majoritarian default rules. Trebilcock, however, reassures us in *Limits* that the project is remains worth pursuing, but with care:

“[W]hether one attempts to divine what the particular parties to a given contract might have agreed to had they focused their attention on the particular issue, starting from the premise that they would rationally have chosen ex ante the joint welfare maximizing rule, or whether one attempts instead to aggregate welfare effects over large numbers of transactions and contracting parties in designing broad, categorical legal rules, the welfare implications of alternative legal rules or regimes are typically inconclusive. Nevertheless, in the case of incomplete contracts, it is not obvious that the legal system has any alternative but to make its best estimates of welfare-enhancing specific or generic background rules, always leaving open to the parties the option of exercising their right of self-determination by contracting out of these background rules in the event that they

⁴Richard Posner and Andrew Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Legal Stud. 83 (1977).

⁵Varouj A. Aivazian, Michael J. Trebilcock and Michael Penny, *The Law of Contract Modification: The Uncertain Quest for a Bench Mark of Enforceability*, 22 Osgoode Hall L.J. 173 (1984).

find them mutually uncongenial.”⁶

Using efficiency as a guide to what contracting parties would choose if they contemplated a given issue is one side of the coin. The other side suggests that we might look to commercial practice as evidence of intent, as well as guidance in resolving complicated efficiency determinations. Courts commonly draw on course of dealings or industry practice as evidence of what the parties intended or at least understood their agreement to be. Although there is some scholarly debate as to the merits of incorporating informal industry practices, the express terms in contractual documents themselves are instructive. Indeed, contract scholars have begun taking advantage of the availability of contract documents on line⁷ to inform efficiency analysis of contract problems.⁸ This essay examines the theoretical complexity of determining the optimal remedies for breach of contract and draws lessons from commercial practice, particularly the strategic combination of conditions and remedies.

When contracts professors meet, they sometimes ask each other about the order in which they cover remedies in their syllabi. Most casebooks place remedies in the first or second chapter and my impression is that most contracts teachers discuss them in class before express and implied conditions. The two principal contracts casebook in Canada, including one coauthored by Trebilcock, cover remedies in the first couple of chapters. Remedies are tied intrinsically with the purpose of contract law. Casebooks commonly describe the compensation principle at the core of contract law, and the expectation measure as the dominant mode of compensation. As I suggest below, it is not clear that the commercial world sees remedies in this way.

In this essay, I suggest that contracts teachers, and most scholars, have fundamentally misunderstood the place of remedies in contracts, and may well be left behind by the brisk pace of evolution in their use in commercial practice. In particular, they still underappreciate the breadth and complexity of incentive and insurance goals that are impacted by the choice of remedy. Parties can address this complexity through a mix of contract conditions and remedies. The relationship between conditions and remedies is often lost in contracts class, when remedies are covered at the outset and conditions near the end of the course. Contract remedies, as we know them, would be unique and simple in a (hypothetical) complete contingent contract.⁹ The contract would provide for the desired performance obligations in each contingency; in some contingencies, that performance might be a monetary payment (perhaps in the form of liquidated damages). The contract would provide explicitly for the desired performance, so there would be no need for expectation damages to induce efficient performance or breach. The parties would

⁶Limits, supra note –, at 245-6.

⁷E.g., www.corimissouri.edu; www.onecle.com, etc.

⁸[add basic cite]

⁹This point is well-articulated in Shavell, supra note –.

intend that the court specifically enforce the contract, and the court should do so. Real world contracts, of course, are not complete. However, they might be partly “complete” with respect to a subset of future states of the world. In particular, the parties may complete that portion of their contract by using conditions, and thereby assign efficient obligations to different states of the world. The more that a contract is complete, in distinguishing among future states through conditions, the less important is enforcement through court-assessed damages to either the alignment of incentives or the allocation of risk. In this sense, conditions and contract damages are substitutes.¹⁰

Conditional obligations raise transaction costs at both the front and back end of the contracting process: it is costly for the parties to anticipate and provide for conditions and costly for the court to verify whether a given condition has materialized. Thus, the parties can control their transactions costs by designing conditions that partition the future states of the world more or less finely, and relying correspondingly more or less on the measure of damages. The parties also manage transaction costs by choosing whether to express conditions as rules or standards.¹¹ With respect to any of these provisions, the courts can provide gap fillers: implied conditions or damages. Examples of the former are material breach (or substantial completion), commercial impracticability, and mistake; while the dominant damages measure is expectation.

As noted earlier, Trebilcock’s work has taught us that the efficiency calculus needed to design implied (default) conditions is contextual and complicated. It is costly and error-prone. So is the measure of damages, but the complexity of damage determinations is usually underappreciated. Most contracts teachers and commentators focus on the difficulty of assessing expectation damages (the “verification” costs). However, expectation damages (even if perfectly assessed) is a crude tool for allocating risks and aligning incentives across all the relevant decisions during the life of a contract. Contract doctrine and contract scholarship fail to appreciate that liquidated damages are often not simply attempts to calculate expectation damages or even to insure the promisor against the uncertainty of realized damages, but rather to opt out of the default expectancy measure itself and even out of the principle of compensatory damages.

Moreover, in addressing the complexity of damage determinations, the parties can use conditions instead of, or together with, damage provisions. In providing for a future contingency that might increase the cost of performance, for example, the parties can agree both to a condition that excuses performance and to a measure of damages that operates when the

¹⁰This argument builds on George G. Triantis, *Unforeseen Contingencies, Risk Allocation in Contracts*, in Boudewijn Bouckaert and Gerrit De Geest, Gerrit (eds.), *Encyclopedia of Law and Economics*, Volume III, Section 4500 (2000)(comparing conditions and damages as means of addressing remote risks).

¹¹See Robert E. Scott and George Triantis, *Anticipating Litigation in Contract Design*, Yale L.J. (2005).

condition is not satisfied. Parties might combine the two instruments by agreeing to conditional damages: instead of a single measure for breach, the measure of damages depends on the realized state of the world. That sophisticated parties use these strategies in commercial transactions can inform the design of default rules and, in particular, should raise further doubts concerning the law's adherence to the compensation principle and expectation damages.

Part I describes the evolution of the understanding of contract remedies and particularly the impact of two important scholarly insights: Fuller and Perdue's categorization of damages and the efficient breach story. Part II discusses briefly the manner in which commercial parties integrate conditions and damage and embed options.

II. Fuller and Perdue and Efficient Breach: milestones or anchors?

My quick review of contracts casebook reveals that a majority cover remedies in the first or second chapter, and conditions much later.¹² This is true of the two leading Canadian contracts casebooks. Swan, Reiter and Bala begin with remedies in their first chapter.¹³ The Waddams-Trebilcock casebook covers remedies in the second chapter after the introduction of perspectives on contract law in the first.¹⁴ These casebooks espouse the compensation principle and justify the dominant remedy of expectation damages at least partly on that basis. They explain the three "interests" protected by contract law – reliance, expectation and restitution -- that were identified in the classic articles of the mid-1930s by Fuller and Perdue.¹⁵ Fuller and Perdue framed the debate about remedies in terms of a choice among these three interests and many scholars have written about the binary choice between reliance and expectation. Fuller and Perdue themselves saw expectation damages as a means of protecting the reliance interest while relieving the promisee of the burden of proving in court her reliance on the promise.¹⁶

¹²E.g., Dawson, Harvey, Henderson, and Baird, *Contracts* (9th Ed. 2008)...

¹³John Swan, Barry J. Reiter and Nicholas C. Bala, *Contracts: Cases, Notes & Materials* (7th ed. 2006).

¹⁴S.M. Waddams, M.J. Trebilcock, J.D. McCamus, J.W. Neyers, and M.A. Waldron, *Cases and Materials on Contracts* (3d ed. 2005).

¹⁵L.L. Fuller and William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 Yale L.J. 52 (1936); *The Reliance Interest in Contract Damages: 2*, 46 Yale L.J. 373 (1937). Waddams, Trebilcock et al., *supra* note –, begin their chapter on remedies with an excerpt from Fuller and Perdue. *Id.*, at 25-7.

¹⁶Fuller and Perdue, *supra* note –, at 62. The justification continues to be popular today: e.g. Robert A. Hillman, *Principles of Contract Law* 135 (2004) ("Most writers explain the expectancy goal as the best method for encouraging people to make and rely on their contracts, which benefits them and society... A damages measure any lower than lost expectancy would undermine people's confidence in their contracts, and a measure larger than expectancy would

Richard Craswell has authored two extremely insightful articles tracing the impact and flaws of the Fuller and Perdue categorization.¹⁷ He persuasively argues that the success of the articles impeded the scholarly analysis of remedies.

“[T]he modern preoccupation with Fuller and Perdue’s three categories has hampered normative analysis. If the key normative question is framed as, “Which of these three interests ought the law to protect?” one is naturally led to look for normative theories in which at least one of these three interests has significance. In fact, though, most normative theories attach no particular importance to any of the three interests identified by Fuller and Perdue.”¹⁸

Craswell suggests that Fuller and Perdue’s classification became so widely adopted at least partly because it fits a “propertized” view of remedies under which the promisor must compensate the promisee for taking her entitlement under the contract. In a sale of goods contract, for example, the promisor is thereby regarded as having conveyed, at the time of the contract, a quasi-property interest in the goods.

[T]he persistence of Fuller and Perdue’s framework may be due partly to the belief (or perhaps the hope) that choosing remedies could be as simple as restoring the value of lost property rights, and that the property rights themselves could be defined or recognized without a lot of difficult work. Most modern scholars, when they take the time to think about it, are aware that neither of these premises is sound. But the persistence of Fuller and Perdue’s framework shows us just how difficult it is, even for modern legal scholars, to fully internalize this point.”¹⁹

discourage them from making contracts because they would be wary of the extent of their liability for breach.”)

¹⁷Richard Craswell, *How We Got This Way: Further Thoughts on Fuller and Perdue*, 1(1) *Issues in Legal Scholarship* 1 (2001); Richard Craswell, *Against Fuller and Perdue*, 67 *U. Chi. L. Rev.* 99 (2000).

¹⁸Craswell, *How We Got This Way*, supra note –, at 6-7. In an earlier article, Craswell argues that various moral grounds for enforcing promise fail to explain why any particular contract remedy would be chosen over the alternatives. Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 *Mich. L. Rev.* 489 (1989). In Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 *S. Cal. L. Rev.* 629 (1988), and in *Against Fuller and Perdue*, supra note –, Craswell demonstrates that none of the Fuller and Perdue measures of damages systematically maximize efficiency, given the numerous actions and decisions over which incentives must be aligned.

¹⁹Craswell, *How We Got This Way*, supra note –, at 20.

As Craswell has points out, the Fuller and Perdue “interests” beg the question. The expectation remedy emerged as the principal remedy no more than a century before their article was published, based on a loose sense of just compensation. Fuller and Perdue sharpened the question by suggesting that the compensation was for the taking of an interest, particularly the reliance interest. If by reliance, Fuller and Perdue meant reliance on the conveyance of the underlying good or service, they neglected many of the reasons for choosing executory contracting over spot exchanges. If they meant reliance on the promise, they provided no reason why contracting parties would seek to convey by promise any of the three interests, as opposed to an infinitely broad range of alternatives that we have begun to observe in practice.²⁰ Without linking the interests to the understanding of one or both of the parties, it is difficult to justify expectation damages on moral grounds.²¹

The advent of economic analysis of law established a connection to the parties’ intent by introducing the goals of efficient incentives and risk bearing, which are assumed to be motivating contracting parties.²² The original and still most famous insight, repeated in virtually all casebooks and many judicial opinions, is the efficient breach story.²³ Richard Posner’s example in *Economic Analysis of Law* provides the classic illustration:

Suppose I sign a contract to deliver 100,000 custom-ground widgets at \$.10 apiece to A, for use in his boiler factory. After I have delivered 10,000, B comes to me, explains that he desperately needs 25,000 custom-ground widgets at once

²⁰Id.

²¹See Craswell, *The Philosophy of Promising*, supra note –. For example, in criticizing Charles Fried’s justification of expectation damages in *Contract as Promise: A Theory of Contractual Obligation* (1981), Craswell writes: “The exact theory of individual autonomy does suggest that individuals should be allowed to make their conduct nonoptional to any extent they choose, by specifying [a remedy] in their contract. But the law must still select one of these remedies as the default rule, and nothing in the notion of individual autonomy gives any reason for favoring the expectation measure over any of the others.” Craswell, at 518.

²²See Steven J. Burton, *Principles of Contract Law* 273 (3d ed. 2006)(“The compensation principle is easily understood at an abstract level. Its justification and practical implications are not so easy to grasp. In recent years, the advent of economic analysis of the law has made the way somewhat easier.”)

²³ The theory is usually attributed to two articles written in the early 1970s: Robert Birmingham, *Breach of Contract, Damage Measures and Economic Efficiency*, 24 Rutgers L. Rev. 273 (1970) and John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. Legal Studies 277 (1972). Richard Posner popularized the story with an example in Richard A. Posner, *Economic Analysis of Law* 57 (1972), and the phrase “efficient breach” seems to come from Charles Goetz and Robert Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: A Theory of Efficient Breach*, 77 Colum. L. Rev. 554 (1977).

since otherwise he will be forced to close his pianola factory at great cost, and offers me \$.15 apiece for 25,000 widgets. I sell him the widgets and as a result do not complete timely delivery to A, who sustains \$1000 in damages from my breach. Having obtained an additional profit of \$1250 on the sale to B, I am better off even after reimbursing A for his loss. Society is also better off. Since B was willing to pay me \$.15 per widget, it must mean that each widget was worth at least \$.15 to him. But it was worth only \$.14 to A – \$.10, what he paid, plus \$.04 (\$1000 divided by 25,000), his expected profit. Thus the breach resulted in a transfer of the 25,000 widgets from a lower valued to a higher valued use.²⁴

Judging by the number of law reviews, casebooks and judicial opinions, that have adopted or taken issue with it, efficient breach is one of the most successful theories of economic analysis.²⁵ The theory also stimulated lively controversy. It was assailed as immoral because the story seemed to undermine the sanctity of promises and permit the offending party to retain the gains from breach. Yet, it filled the theoretical void surrounding the compensation principle and the expectation default measure of damages, and thereby cemented their place in common law doctrine.²⁶

A brief comparison between the first and second Restatement of Contracts illustrates the significant impact of the efficient breach story. The first Restatement (approved and promulgated by the American Law Institute in 1932) simply stated the compensatory principle of expectation damages -- to put the injured party in as good a position as if the promisor had performed – and offered no justification beyond the citation of judicial opinions.²⁷ Work on the Second Restatement began in 1962 and was completed in 1979, after fourteen drafts. Its

²⁴Posner, *supra* note –, at 57.

²⁵The literature debating and commenting on the theory is too long to list, but prominent contract scholars continue to write about it over thirty years later. E.g., Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 Ford. L. Rev. 1085 (2000); Barry E. Adler, *Efficient Breach Theory Through the Looking Glass*, 83 N.Y.U.L.Rev. 1679 (2008); Richard R.W.Brooks, *The Efficient Performance Hypothesis*, 116 Yale L.J. 568 (2006)(proposing that ex post efficiency gains may also be produced by an alternative default that gives the promisee the choice between performance and disgorgement of the promisor's gain from breach; the promisee rather than promisor enjoys the efficiency gains under this rule).

²⁶E.g. Ayres and Speidel, *Studies in Contract Law* 198-212 (7th ed. 2003)(expectation damages provide a surrogate for reliance, which encourages people to deal with those who make promises, and they promote efficient decisions to perform or breach). Charles Fried accepts expectation damages as a default rule. *The Convergence of Contract and Promise*, 120(1) Harv. L. Rev. Forum 1, at 7 (2007)

²⁷Restatement of Contracts §329, ct. a (1932).

principal Reporters were prominent contracts scholars.²⁸ Not surprisingly, therefore, the Second Restatement adopts the Fuller-Perdue classification of damages measures and identifies expectation damages as the dominant measure of compensable loss. The Introductory Note to the chapter on Remedies also observes that “[t]he answer provided by at least some economic analysis tends to confirm the traditional response of common-law judges in dealing with this question.”²⁹ This is followed by the Reporter’s Note, which relates the efficient breach story and then notes:

“This conclusion accords well with the assumption of contract law that the principal purpose of the rules relating to breach is to place the injured party in as good a position as he would have been in had the contract been performed. Awarding damages on this basis to protect the injured party’s ‘expectation interest’ gives the other party an incentive to break the contract if, but only if, he gains enough from the breach that he can compensate the injured party for his losses and still retain some of the benefits from the breach.”

The impact of efficient breach is perhaps even more apparent in the contrast between the two sets of provisions dealing with liquidated damages and penalties. Section 339 of the First Restatement states that the liquidated damages are enforceable only if they are “a reasonable forecast of just compensation for the harm that is caused by the breach”. Comment a explains that “punishment... without regard to the extent of the harm that he has caused, is an unjust and unnecessary remedy”. Comment b adds that parties must adhere to the “rule of just compensation”. The root of the notion of just compensation appears to coincide with the origin of the penalty rule in late-17th century equity courts. These courts granted relief from the common law’s strict enforcement of penal bonds issued by promisors to back their contractual commitments. The equity courts limited the promisee’s recovery to the amount of the loss caused by the breach.³⁰ Where the first restatement failed to connect expectation damages to the intention of the parties, it adopted the penalty rule that flew in the face of clear intent, under a vaguely formulated conception of compensatory justice.

The Second Restatement replaces the references to just compensation with explicit reference to economic rationale and to public policy. Section 356(1) requires that the liquidated damages must be “reasonable in the light of the anticipated or actual loss caused by the breach”.³¹ The section deletes the reference to justice and states that unreasonably large liquidated damages are unenforceable “on grounds of public policy”. Comment a elaborates on

²⁸Professor Samuel Williston was Chief Reporter and Professor Arthur Corbin was Special Adviser and Reporter on Remedies. Allan Farnsworth served as reporter from 1971 until completion in 1979.

²⁹ Restatement 2d Contracts, Chapter 16 (Remedies)(Introductory Note), at 100 (1979).

³⁰E. Allan Farnsworth, *Contracts* §12.18 at 812 (3d ed. 2004).

³¹This is similar to and no doubt inspired by §2-718(1) of the Uniform Commercial Code.

the public policy grounds by referring to “the principle of compensation” (omitting the earlier adjective “just”) and adding that “[p]unishment [for breach of a promise]... has no justification on either economic or other grounds”.³² The Reporters’ Note, authored by Professor Alan Farnsworth, cites several articles in law and economics, including one by Charles Goetz and Robert Scott,³³ that link the analysis of efficient breach to liquidated damages.³⁴

Although efficient breach responded to the theoretical void surrounding expectation damages, it has commanded attention disproportionate to either its predictive or normative value. Like Fuller and Perdue’s categorization of contract interests, the efficient breach story is a very rough description of judicial practice: courts often award damages that are deliberately lower and even higher than expectation.³⁵ As a normative theory, efficient breach occupies a very narrow parameter space and addresses one of a number of economic objectives in contracting: the efficient decision to execute a promise or breach (known to economists as “ex post efficiency”). In 1988, Craswell wrote that too much ink had been spilled over the question of whether ex post efficiency can be attained as, or more, easily through renegotiation as through litigation to enforce expectation damages.³⁶ Some scholars expressed concern that the practice of undercompensating promisees (for losses that are deemed speculative, unforeseeable and avoidable) would undermine the goals of ex post efficiency.³⁷ Craswell noted that this preoccupation with efficient breach distracted scholars from addressing the range of other pre-breach incentives that should bear on the choice of remedies. To be fair, scholars had identified a tradeoff under expectation damages, between the efficiency of ex post trade decisions and the

³²On the question of subcompensatory damages, the restatements leave the matter to the inquiry of unconscionability. In describing the standard, comment 1 to UCC §2-719 says that there must be “at least a fair quantum of remedy for breach of the obligations or duties outlined in the contract”.

³³Supra note –.

³⁴Farnsworth’s leading Contracts treatise cites the benefit of efficient breach as the justification for the ban on punitive damages. Farnsworth, *supra* note –, at 763.

³⁵Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. Cal. L. Rev. 629 (1988).

³⁶See, e.g., *Walgreen Co. v. Sara Creek Property Co.*, 966 F. 2d 273 (1992)(Posner, J.). Specific performance was justified on this basis in Alan Schwartz, *The Case for Specific Performance*, 89 Yale L.J. 271 (1979)(proposing that the promisee have the choice between specific performance or expectation damages).

³⁷[cite]

inefficiency of overreliance (before and after breach).³⁸ However, the literature largely neglected a host of other decisions preceding breach, including the promisor's precautions against breach during the course of the contract, as well as search, screening and disclosure at the time of contracting.³⁹ One might also cite the stubborn resilience of the penalty rule as further evidence of the preoccupation with efficient breach. The rationale of efficient breach contributed to the friction facing contracting parties who, for good reason, wished to contract away from the default of compensatory damages.⁴⁰

Perhaps as a result of the compelling force of the efficient breach story, contracts analysis seemed to lag behind the economic analysis of torts, in which moral hazard was central. Over a decade elapsed from the birth of efficient breach until contract scholarship caught up with the analysis of incentives and risk bearing in torts.⁴¹ In 1984, Trebilcock's article on contract modification was innovative in that it sought to balance the pursuit of ex post efficient performance with the investment in precautions against contingencies that would render performance more onerous. The article's analysis of modification made clear that renegotiation might achieve ex post efficiency, but can disturb ex ante efficiency in the process. A year later, Robert Cooter published *Unity of Torts, Contract and Property*, which more broadly brought contract analysis up to speed with torts.⁴²

If Fuller and Perdue "propertized" contract remedies, then efficient breach might be said to have started gradually the "tortification" of contracts analysis by focusing on the social welfare gains produced by incentive alignment and, to some degree, risk allocation. A number of scholars have observed the complexity of accounting for and weighing the factors that bear on the determination of optimal damages.⁴³ Just as with Trebilcock's assessment of the more

³⁸E.g., Steven Shavell, *Damage Measures for Breach of Contract*, 11 Bell J. Econ. 466 (1980).

³⁹"What is surprising, however, is the number of economic analyses which nonetheless proceed as though the perform-or-breach decision were the only decision affected by contract remedies. As a result, many noneconomists fall into this error as well." Craswell, *Contract Remedies*, supra note –, at

⁴⁰Robert E. Scott and George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 Colum. L. Rev. 1428 (2004).

⁴¹[elaborate]

⁴²Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 Calif. L. Rev. 1 (1985); Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. Cal. L. Rev. 629 (1988)

⁴³See, e.g., Eric Posner, *Economic Analysis of Contract Law After Three Decades: Success of Failure*, 112 Yale L.J. 829 (2003); Craswell, supra note –; Scott and Triantis,

efficient risk bearer, the determination is complex and highly context-dependent. However, if we pay heed to Trebilcock's counsel reproduced above concerning the development of default terms in the face of complexity,⁴⁴ we serve the social interest by doing the best we can while ensuring that informed parties are free to opt out if they wish.

Thus, the accumulation of various insights left a tall order for remedies: to achieve efficiency across a broad range of incentive and risk-bearing objectives. In this regard, several points seem clear. First, as we expand the range of incentive and risk-bearing concerns that remedies are intended to address, we can no longer justify the doctrinal norm of either compensation or expectation damages on the grounds that most parties would agree to either. Efficient breach can no longer carry the cause on its own. Second, we ask too much of a single tool if we expect that the choice of breach damages (by default or by the parties' stipulation) can efficiently allocate risks and align incentives. A second-best compromise among goals is likely to leave a lot of room for improvement. In the next section, I explain how the combination of conditions and remedy choices can take on the various incentive and risk-bearing objectives individually, to provide a superior approach. Third, in light of this tailoring of conditions and remedies, the remedial default under contract law may be complicated, but perhaps less central to contract law than most contracts professors would think.

The convergence of tort and contract remedy analysis was incomplete in another respect. The connection between the social welfare gains from efficient incentives and the intent or personal sovereignty of the parties was still largely missing until Trebilcock's path-breaking work in *Limits*. Once the parties' intent is brought into the picture, the importance of information obstacles, particularly at the time of contracting, comes to light. The post-*Limits* era developed a sophisticated understanding of the informational features of contracts and contract law, as well as a more sophisticated account of opportunities for efficient risk transfer in commercial contracts. Commercial contracts are products in their own right, distinct from the underlying goods or services. Value can be created by innovating, developing and marketing new contractual products. The next section also demonstrates how this trend, too, has moved remedies further away from the compensatory purpose attributed to them by the common law.

III. Remedies in the Incomplete Contracts Era

Trebilcock wrote *Limits* at a time when the economic theory of incomplete contracts and mechanism design began to filter into legal scholarship.⁴⁵ At the time, he joined the pioneers in

Embedded Options, supra note –.

⁴⁴See quotation from *Limits*, at supra note –.

⁴⁵E.g., Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87 (1989); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 Journal of

incorporating this theory in the legal scholarship of contracts, particularly in the chapters in *Limits* on information imperfections. Incomplete contracts directed the attention of scholars to the concerns raised by litigation (or settlement) costs, as well as the costs of asymmetric information at the time of contracting and at the time of renegotiation.⁴⁶ Contract designers and tort-law makers share the concerns about prospective litigation (and settlement) costs and error. In both tort law and contracts, there is an important connection between damages and the choice between rules and standards in defining obligations. In particular, standards (such as negligence, good faith or reasonableness) raise litigation costs incurred in the application of the standard to the facts of each case. Negligence requires the court to assess the cost of precautions, the risk of harm and the amount of loss that might occur under different contingencies. However, once the act or omission is determined to be negligent, the measure of actual loss is much less important. It need only be at least as high as necessary to deter the negligent behavior; the concern with overdeterrence is absent.⁴⁷ Instead of a standard, the contracting parties or lawmaker may opt for a rule-based approach. Of course, if those rules are “complete” in the sense of matching efficient obligations to each future state of the world, the choice of remedy is similarly simple – high damages or injunction such as specific performance – and the enforcement is relatively straightforward. If the rules are “incomplete” – for example, strict liability for harm – the court avoids the costs of applying a standard, and relies much more heavily on the ability of a court to assess actual loss – and in a manner that the relevant actor can predict.⁴⁸

Legal Studies 271 (1992).

⁴⁶I distinguish between renegotiations and settlement along the lines that renegotiations occur when physical performance is still possible (as opposed to settlements that are payments of money after performance is no longer feasible).

⁴⁷In a recent symposium on fault in contract law, Eric Posner and Richard Craswell each described this tradeoff between the information demands of strict liability and negligence, analogizing willful breach to a negligence standard that screens for clearly inefficient breach. Richard Craswell, *When Is a Willful Breach ‘Willful’? The Link Between Definitions and Damages*, 107 Mich. L. Rev. 1501, 1510-11 (2009) (“definitions of ‘willful’ that reach only inefficient breachers can be paired with damage awards that are quite high, and do not need to be calibrated very precisely; but definitions of ‘willful’ that include efficient breachers will require damage awards that are more restrained.” *Id.*, at 1515); Eric A. Posner, *Fault in Contract Law*, 107 Mich. L. Rev. 1431 (2009). Posner observes that strict liability requires the promisor to pay damages even if breach is efficient, leading the promisor to raise the contract price *ex ante*. In essence the promisee would buy insurance against contingencies that will render performance infeasible despite the efficient precautions of the promisor. He implies that the promisor is rarely the superior bearer of such exogenous risk, but this premise is unsupported empirically. See *infra* text at note –.

⁴⁸*Id.*

Later in this section, I explain why this insight is important and how it undercuts the rationale for beginning a contracts course with remedies. Before proceeding, however, it is worth commenting also on how incomplete contracts theory distinguishes contracts from torts. In contractual cases, the parties have the opportunity to design their obligations in order to address information imperfections. The objective of matching high-value buyers with low-cost sellers of contractual packages has an analog in tort, at least in theory: tort law provides incentives for high-risk tortfeasors to avoid the more vulnerable victims. However, tortfeasors are much less likely to have information about their victims than contracting parties do about each other. More importantly, the parties to a tort do not have the opportunity or incentive to communicate information the way they do in contracts. Their inability to interact *ex ante* also deprives the parties to a tort from agreeing *ex ante* to shape future litigation rules to their specific circumstances. In contrast, contracting parties can cooperatively communicate important information to a future court and, to a large extent, can modify the litigation process that will resolve future disputes.⁴⁹

Contracting surplus is derived not solely from the actions of the parties after contracting (whether before or after breach), but also from their decision to contract. Fuller and Perdue led contract analysis down the wrong track by equating a contract for the delivery of a good or service, with a specific interest in that good or service (in most cases, expectation or reliance). In fact, the point of an executory contract is to create value beyond the intended exchange of goods or services. The intent of a contract is better understood when the contract and the underlying good or service are seen as distinct assets.⁵⁰

Incomplete contract theory views contracts as a set of conditional obligations exchanged between the parties. A contracting seller does not sell the good, but rather a product that consists of a package of state-contingent rights.⁵¹ The contracting surplus is the difference between the value of the package to the buyer and the cost to the seller. As between any given seller and buyer, the design of the package can increase this surplus. This derives partly from the

⁴⁹See Robert E. Scott and George Triantis, *Anticipating Litigation in Contract Design*, Yale L.J. (2005).

⁵⁰Derivative contracts provide a useful paradigm: the issuer has no property interest in the underlying asset, but sells something of value to the purchaser. See *infra* note –, and accompanying text.

⁵¹[Arrow-Debreu security]. See, e.g., Fried, *supra* note –, at 5 n16 (“A promise is property, like a call option that can be traded on a futures market and may actually be embodied in a piece of paper”). In contrast, note Karl Llewellyn’s statement that “[a] contract is no equivalent of performance; rights are a poor substitute for goods”, Karl N. Llewellyn, *What Price Contract? - An Exercise in Perspective*, 40 Yale L.J. 704, 724 (1931), and the official comment of the UCC (which may well have been drafted by Llewellyn) that “the essential purpose of a contract between commercial men is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit.” UCC 2-609 cmt 1.

behavioral incentives yielded by the package, but also the divergent risk profiles and preferences of each party. Social welfare is further enhanced when the person who values the package the most purchases it from the person who can supply it at the lowest cost.⁵² This may be different from the person who can supply the underlying good or service at the lowest cost. One of the goals of contract design is, accordingly, to ensure that these parties meet, recognize and contract with each other. Finally, a seller (or buyer) may need to invest in preparing these products and marketing them to potential buyers. They may not have the incentive to do so if they cannot recoup this investment in the price of the contract. Efficient breach theory has entrenched the compensation norm so firmly in contract doctrine that the parties face not only a sticky expectation damages default, but also a penalty rule that raises the cost of innovative contracting.⁵³

As an illustration, consider that innovative contract “product” designs often bundle the delivery of the good or service with insurance against exogenous risks, based on some risk bearing advantage enjoyed by the seller. The insurance product here is quite different from that contemplated in the more conventional analysis of risk allocation in contract damages,⁵⁴ where the risk being allocated concerns increases in the cost of performance. In an earlier article, Robert Scott and I cite the airline ticket as an example in which the seller bundles insurance with the underlying service, and charges for it. As a result, the parties rationally agree to damages higher than expectation. Suppose that a buyer purchases a ticket with a fare of \$350, and a penalty of \$100 if she decides not to take the flight. As a measure of damages, \$100 may well be significantly more than the expected loss suffered by the airline if the buyer decides not to take the flight; in fact, the airline can often resell the ticket at a higher fare. Framed as alternative promises, the buyer’s contract to either pay \$350 for the flight or \$100 for no flight, seems odd. Ticket buyers understand, instead, that they are effectively paying \$100 for the option to take the flight for \$250.⁵⁵ The option protects them against fare increases and against the risk that the flight will be sold out. Scott and I argued that many other contracts (or parts of them) may be framed in roughly this way. The expected liability in damages is the price that a party exchanges for the option to pay the balance of the price in return for the promised consideration. The regulation of damages, through default or mandatory rules, is thereby tantamount to regulating these option prices.

⁵²One might argue this is also a goal of tort law: to match high-risk tortfeasors with the least vulnerable victims, but the degree of information asymmetry is so much more severe than in most contracts and, more importantly, the parties do not have the opportunity to signal/screen.

⁵³Scott and Triantis, *supra* note —.

⁵⁴E.g. [cite]

⁵⁵To keep the description simple, I assume that the airline’s obligation is specifically enforceable. The basic point remains even if the airline’s obligation is enforceable through damages, and there are reciprocal options.

Buyers value the option to take a given flight at a given exercise price, depending on their individual circumstances. An airline should be willing to sell any option that costs the airline less than the price it can charge its buyer. It can choose among alternative pairings of option price and exercise price (or in conventional terms, penalty and fare). Like the seller of an ordinary good or service, an airline will choose the option features that allow it to capture as much economic rent as possible. The important implication for contract law is that the price of the option – the penalty – is neither simply the loss suffered when the traveler decides not to take the flight nor the cost to the airline of writing the option. The airline industry is not particularly competitive, so the price can be expected to lie somewhere above the cost to the airline and below the value to the buyer. In a world in which airlines aggressively price discriminate among passengers and charge separately for luggage, meals, entertainment and leg room, it is surprising that they do not vary the penalties somewhat among different routes in order to increase their rents from the sale of options.⁵⁶ They continuously vary the fares on a flight on the basis of a wide range of information, including the rate at which the fixed number of seats on a flight are being purchased. One might imagine that they could similarly change daily the penalty as well.

In this light, the penalty rule is an unjustifiable instance of price regulation that inhibits innovation.⁵⁷ Contract law generally refrains from policing high prices due to market power. Even if the law were to limit the airlines to a fair price, that price ought to include a return on the cost of developing valuable options and thus may be higher than the cost of the option (and the loss suffered when the buyer walks away from it). To be sure, the supercompensatory penalty may lead to inefficient “performance”: if the traveler values the flight at \$275 and the airline can resell the ticket to someone who values it at \$300, the traveler has the inefficient incentive to fly. This efficiency loss, however, is probably outweighed by the gain from the insurance provided by the airline.⁵⁸

As suggested earlier, contract damages provide but one set of tools to address the various problems of incentives, information and risk allocation in incomplete contracts.⁵⁹ Thus, remedies are best understood in relation to the other mechanisms. I have previewed the relationship earlier, connecting the significance of remedies to the choice between incomplete

⁵⁶For an interesting and very recent innovation in selling options on tickets to sporting events, see OptionIt at www.optionit.com.

⁵⁷See Scott and Triantis, *supra* note –.

⁵⁸The challenge of providing default damages is much more daunting when they are essentially option prices. If an ordinary sales contract fails to specify the price, the court either declines to enforce the contract on the grounds that it is indefinite or fills the gap with a price that is reasonable under the circumstances. In a sales contract, if the good has been delivered, the court will usually order that a reasonable value must be paid. U.C.C. §2-305; Restatement 2d Contracts §33.

⁵⁹See Triantis, *Unforeseen Contingencies*, *supra* note –.

rules and standards. First, the parties may provide specifically for “complete” conditional performance obligations in particular contingencies. Consider Richard Posner’s classic widget example of efficient breach. Instead of adopting the default of expectation damages, the parties might have provided in their ex ante contract that the seller is excused from delivering the widget if she receives a bona fide offer higher than the value of the good to the buyer. The benefit to the seller from being free to sell to a third party under this condition can be shared with the buyer ex ante in the contract price rather than through expectation damages. In this way, the seller rather than buyer bears the risk that the higher offer will fail to materialize, and the seller is probably the superior risk bearer because of her information advantage.⁶⁰ Moreover, when the parties agree to the condition, they allow the choice of damages for breach to address other incentive or risk bearing goals. Suppose, for example, that breaches motivated other than by a higher third party offer are inefficient. Then, a high and fixed stipulated penalty for breach combined with the aforementioned condition, would protect the reliance investment of the buyer without jeopardizing efficient breach upon the appearance of a new buyer.

An incomplete contracts theorist might reject this contract on the grounds that (non)performance is conditioned on a factor that a court is unable to verify: the buyer’s valuation of the good and the bona fides of the third party offer. Yet, these obstacles of litigation costs and the risk of judicial error do not seem to deter parties from adopting such vague terms in the real world.⁶¹ In corporate acquisition contracts, for example, the target’s board promises to recommend the deal to the stockholders, who are required to approve the deal by vote. In a majority of strategic deals, the contract excuses the board if it determines in good faith that its fiduciary obligations require the withdrawal or modification of the recommendation. In over a third of these contracts, this excuse is further qualified by requiring that the withdrawal or modification is in response to “an unsolicited, bona fide written offer” made to the target, that the board determines in good faith to be superior.⁶²

Albert Choi and I have demonstrated that parties can efficiently condition performance on vague provisions that are both costly to litigate and prone to judicial error of interpretation or fact finding.⁶³ We show that the prospect of litigation over vague provisions may help to reveal private information (at the time of contracting or enforcement) that might otherwise prevent agreement. Thus, it is quite possible that the parties would opt for a set of conditions based on vague standards over incomplete rules backed by damages. Our analysis offers one explanation

⁶⁰Eric Posner may disagree. See supra note –.

⁶¹See Scott and Triantis, supra note –.

⁶²ABA Section of Business Law, 2009 Strategic Buyer/Public Target Mergers & Acquisitions Deal Points Study.

⁶³Albert Choi and George Triantis, *Completing Contracts in the Shadow of Verification Costs*, J. Legal Stud. (2008); Albert Choi and George Triantis, *Strategic Vagueness: The Case of Corporate Acquisitions*, 119 Yale L.J. (forthcoming 2010).

why vague promises based on “best efforts”, “materiality” or “reasonableness” are commonplace in commercial agreement, despite the fact that they invite costly and error-prone litigation. We also show how liquidated damages may be used to manipulate litigation stakes and incentives to produce the desired signaling or screening effect. The important implication for the purposes of this essay is that the damages are not meant to be compensatory either in our model or in practice. Vague performance obligations are generally not backed by expectation damages. They are occasionally specifically enforced (particularly in the context of corporate acquisitions), and the sanction for violating them is often the termination of the agreement.

This insight sets up the following choice in contract design. The parties can provide for efficient obligations in a “complete” contingent obligation, either by specific rules or vague standards, or they can try to align incentives more generally by using incomplete rules with damages. State-provided default provisions can be divided into similar categories: they can provide implied terms or apply the default remedy. If the contingency is completely handled by an explicit or implied contract provision, then that provision should be specifically enforced as provided for. If not, then damages must be calibrated to yield the efficient decision. These alternatives are illustrated by considering the treatment of remote risks under (i) force majeure clauses, (ii) the doctrines of commercial impracticability and frustration and (iii) expectation damages. I briefly return to the choice among these alternatives below.

Two types of common commercial contracts illustrate the limited role played by damages in some contexts: loan and franchise agreements. Each type of agreement relies far more on conditions – particularly in the form of detailed representations, warranties and covenants – that trigger termination rather than the right to sue for expectation damages. The most significant remedy available to a franchisee upon breach by the franchisor is termination. The absence of expectation damages from loan agreements might be striking to a law student who has taken first year contracts. Upon the borrower’s default, the lender is entitled to accelerate the maturity of the debt and collect the principal, accrued interest and perhaps a fee or two. However, loan agreements exclude the possibility that the lender might be compensated for the injury it suffers when the market rate of interest has fallen well below the contract rate. In an interesting recent development, some loan agreements provide a schedule of interest rate adjustments that are triggered by covenant violations. This mix of conditions and sanctions lead to the following observation.

Conditions and remedies may be regarded as alternatives, but there are attractive intermediate strategies under which they are combined into contingent remedies. The violation of various conditions might give rise to different levels of damages, none of which is equal to the expected loss of the promisee. Under the classical view of the treatment of remote adverse risks, the parties have a choice between excusing performance on the occurrence of a contingency, either explicitly under force majeure or through the default of commercial impracticability, or permitting the promisor to breach and pay damages when they are less than the cost of performance. This all-or-nothing choice is unnecessarily constrained. Indeed, the rigidity in damages under contract law doctrine may explain the emphasis placed on implied conditions, such as the doctrine of impracticability. In *Limits*, Trebilcock is critical of these excuse

doctrines on the grounds that they are crude instruments with which to deal with multiple incentive and risk bearing objectives.⁶⁴ If the legal regime softened its allegiance to the compensation principle, he would likely find a more satisfactory approach that incorporates more finely tuned conditional damages.⁶⁵

Before closing, I note a recent trend in corporate acquisition agreements that reflects the attraction of the conditional remedies described above. These agreements often provide for a general remedy of specific performance, and the Delaware Chancery Court has indicated that it will typically honor the parties' intent in this respect. Acquisition agreements now commonly also entitle the buyer to walk from the deal by paying reverse termination fees (equivalent in effect to liquidated damages) under specified conditions.⁶⁶ Practitioners refer to this feature as "optionality". An interesting and very recent development is that these fees are increasingly tiered, varying according to the conditions that trigger them. For example, a buyer can walk from the deal by paying distinct fees if the reason for not closing is (a) that regulatory approvals were not obtained, (b) that financing for the deal fell through or (c) shareholders refused to approve the merger or acquisition. The variation in fees cannot be explained by differences in the consequent loss suffered by the target when the acquisition is aborted. Rather, the schedule presents a series of conditional options and buyers, in turn, compensate their investment bankers well to value these options.

IV. Conclusion

To Fuller and Perdue, a contract created an interest in the subject matter of the contract – a good or a service – and the law protected that interest by awarding damages for breach. The theory of efficient breach contemplated that the failure to deliver the good or service may be excused if efficient; expectation damages are the means by which the law ensured ex post efficiency. In the academic understanding of remedies, efficient breach was soon followed by a broadening of the incentive concerns that might factor into the optimal level of damages and by some effort to allocate efficiently risks of contingencies that might induce breach. These

⁶⁴It is interesting that he views ex post efficiency as the less important goal in this context: "Only in cases where the efficient allocation of risks is indeterminate, both subjectively and objectively, or where the risk in question is extremely remote so that the expected costs of bearing it do not induce significant efficient precautionary responses, is it likely that the static efficiency gains from recontracting will outweigh the dynamic efficiency losses." Trebilcock, *Limits*, supra note –, at –.

⁶⁵The argument that damages may achieve more effective allocation of remote risks than excuse is advanced in Michelle White, *Contract Breach and Contract Discharge Due to Impossibility: A Unified Theory*, 17 J. Legal Stud. 353 (1988) and Alan Sykes, *The doctrine of commercial impracticability in a second-best world*, 19 J. Legal Stud. 43-94 (1990).

⁶⁶See Choi and Triantis, *Strategic Vagueness*, supra note –.

developments left a tall order for remedies: to achieve efficiency across a broad range of incentive and risk-bearing objectives.

Incomplete contracts theory ushered a new phase in which we need to view the contract as a package being sold, rather than simply arranging for the sale of the underlying good or service. Like the underlying good or service, the contract itself may be the product of innovation, development and marketing. And, like the good or service but as a distinct product, the contract may be worth significantly more to the buyer than the seller. In addition to being concerned with aligning incentives, contracts are designed to address significant information asymmetries that impede contracting, renegotiation and enforcement. As noted earlier in this essay, Michael Trebilcock is one of a handful of contracts scholars who deserve credit for explaining the central role of information imperfections and moving our understanding of contract law away from the simple theory of efficient breach. Incomplete contracts offer a valuable model for understanding evolving practices in commercial and corporate contracting. In particular, this essay seeks to shed light on the important relationship between contract remedies and conditions, whether specific or vague, and whether express or implied. The central and distinctive role assigned to remedies by Fuller and Perdue, and by efficient breach, is no longer justified under the incomplete contracts story. Remedies are best explained in a new light *after this* story has been told.