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Efficient Breach

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Efficient Breach

*Gregory Klass**

The most widely known, and widely criticized, economic claim about contract law is the theory of efficient breach. The simplest version of the theory recommends expectation damages because expectation damages give parties a reason to perform when and only when performance will increase overall social welfare. Oliver Wendell Holmes famously wrote 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."[1] The simple theory of efficient breach advances a prescriptive version of the Holmesian Heresy. Where Holmes attributed the disjunctive view of contract obligations to the "bad man," the efficient breach theory attributes it to the law. A contractual duty is a duty to perform or pay damages because, having priced breach correctly, the law wants the promisor sometimes to choose breach.

Many contract theorists find this theory of efficient breach deeply unsatisfactory. To those who adopt nonwelfarist approaches, the theory's prescriptive claim can look like a *reductio ad absurdum* of welfarism. Any theory that claims that contract law should encourage the moral wrong of breach must be based on a false premise. Thus contract theorists who emphasize promissory obligations, principles of corrective justice, autonomy, or other nonwelfarist principles commonly either take the theory of efficient breach as their foil or simply ignore it.

This is unfortunate. An adequate theory of the functions or justifications of contract law requires a clear understanding of what contract law can do, which demands thinking about legal design. Economic work on design questions, including the theory of efficient breach, has produced significant results. Those results are independent of the social welfare principle that early proponents of efficient breach employed, and contract theorists should attend to them.

In fact, despite the attention the simple theory of efficient breach still garners, few economically oriented scholars would today defend it.[2] But many noneconomist contract theorists have paid little attention to subsequent economic work in the area.

* This chapter benefited from comments at the Bentham House Annual Conference 2013: The Philosophical Foundations of Contract Law, at University College London, May 10–11, 2013, as well as conversations with my colleague Josh Teitelbaum.

[1] Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 462 (1897), *reprinted in* 110 Harv. L. Rev. 991, 995 (1997).

[2] As Richard Craswell explains: "Because these arguments are so simple, they are easily reproduced (and also easily criticized), so it is not surprising that they continue to loom large in much of contracts scholarship… . In point of fact, though, most economists have long since moved on to a much more complex analysis of efficiency and contract law." Richard Craswell, *Two Economic Theories of Enforcing Promises, in* The Theory of Contract Law: New Essays 19, 26 (P. Benson ed., 2001).

This chapter provides an overview. I begin by recounting the simple theory of efficient breach, the theory noneconomist scholars most often criticize. After describing the common criticisms, I canvass four economic critiques of the simple theory. Contemporary economic analyses of contract remedies, though they leave room for efficient breach, are far more nuanced than the simple theory suggests. I then identify three important lessons contract theorists, no matter what their orientation, can learn from a revised, more sophisticated theory of efficient breach. First, remedies often affect other terms, including the price. Second, as a result, parties themselves often want efficient remedies. Third, lawmakers must decide whether, when, or how parties should be able to choose the remedy. These lessons about the design of contract remedies pose questions that any theory of contract law should be equipped to answer. They also suggest design options nonwelfarist theories might find useful.

I. The Simple Theory of Efficient Breach

The simple theory purports to solve a puzzle posed by Lon Fuller and William Perdue in their 1936 article, *The Reliance Interest in Contract Damages: 1*.[3] Fuller and Perdue famously distinguish three "interests" of the nonbreaching party in obtaining relief, each corresponding to a damage measure. In a contract between A and B that A breaches, protecting B's restitution interest requires the return of any benefit that B directly provided A.[4] Protecting B's reliance interest requires compensating B for any change in B's position based on the expectation of A's performance, thereby putting B in the place B would have occupied had B not entered the contract. Protecting B's expectation interest requires providing B its expected gains from the transaction, putting B in the position B would have occupied had A performed the contract. The expectation measure typically exceeds the reliance measure, which is often greater than the restitution measure. Fuller and Perdue argue that the reasons for providing restitution and reliance-based damages are easy enough to intuit. The reasons for expectation damages not so much. "[T]he promisee who has actually relied on the promise, even though he may not thereby have enriched the promisor, certainly presents a more pressing case for relief than the promisee who merely demands satisfaction for his disappointment in not getting what was promised him."[5] The puzzle is why the law should "'compensate' the plaintiff by giving him something he never had."[6]

The simple theory of efficient breach has an answer: the expectation remedy maximizes social welfare. As Richard Posner put the major premise, "contract remedies should… give the party to a contract an incentive to fulfill his promise unless the result would be an inefficient use of resources."[7] Of the three measures, only expectation damages provide an incentive to perform if and only if performance is efficient. The reason can be explained with an example.

[3] L. L. Fuller & William M. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 Yale L.J. 52 (1936).

[4] "Directly" to distinguish restitution from disgorgement, which requires the breaching party to turn over all of the benefits from breach.

[5] Fuller & Perdue, *The Reliance Interest in Contract Damages*, at 56.

[6] Fuller & Perdue, *The Reliance Interest in Contract Damages*, at 52–3.

[7] Richard A. Posner, Economic Analysis of the Law, 56 (1972).

Suppose on January 1, Seller enters into a contract to sell goods to Buyer. Seller is to provide Buyer 100 units on or before July 1. Buyer is to pay $10 per unit, or $1,000 total, due 30 days after delivery. Seller is going to manufacture the goods in question, and expects to spend $8 per unit on production, shipment, and overhead. Buyer is going to use the units to manufacture other goods. On top of its $10 per unit payment to Seller, Buyer's costs of production, resale, and overhead are $6 per unit, and it will sell its product for $18 per unit. For each unit, therefore, the transaction generates $4 in new value: Buyer and Seller together invest a net $14 to produce a product worth $18 to willing purchasers. Out of this $4 surplus, Buyer takes $2 and Seller takes $2. If their relative bargaining strength were different, Seller and Buyer might divide that surplus differently. At a price of $9 per unit, Seller would take $1 and buyer $3; at a price of $11, the division would go the other way. The limiting factors are that Seller is unwilling to sell for less than $8, and buyer to buy for more than $12. Neither will agree to a losing deal.

Although the transaction looks like it will create value when the parties agree to it, things could change before the time of performance. A good deal in January might look much less attractive in April. The efficient breach theory considers two types of changes: good news and bad news.[8]

The more common scenario in the literature involves good news. Suppose on April 1, Third Party contacts Seller and offers to purchase 100 units for $1,300, or $13 per unit. Third Party is a competitor of Buyer and is willing to pay more for the goods because it has a new, less expensive production method. Whereas Buyer's production costs are $6 per unit, Third Party's costs are $3. Seller does not have the capacity to produce more than 100 units and so can sell to Third Party only if it breaches with Buyer. To keep things simple, suppose on April 1, Buyer has not yet invested any resources in the transaction and if Seller breaches, Buyer will not be able to get replacement goods elsewhere.

Sale to Third Party is more efficient than sale to Buyer. The transaction between Seller and Buyer creates $4 of value for each unit sold ($18 market price – $8 Seller costs – $6 Buyer costs). Sale to Third Party, on the contrary, will produce $7 per unit ($18 market price – $8 Seller costs – $3 Third Party costs). If we want to maximize social welfare (as measured in dollars), we want Seller to breach the contract with Buyer and sell to Third Party.

If Seller is a purely self-interested rational utility maximizer and has no other reason to perform or breach, expectation damages produce that result. The expectation measure requires Seller to pay Buyer for the profits Buyer would have earned from the transaction plus any costs Buyer has already incurred. On the facts, this means a transfer from Seller to Buyer of $2 per unit. If Seller sells to Third Party, Seller earns $5 per unit ($13 price – $8 production costs). Seller will therefore choose to breach, pay Buyer the $2 per unit in damages, and emerge with $3 per unit net profit, one dollar more than Seller would have made by performing.

[8] Economic analyses typically treat the good-news and bad-news scenarios as functionally equivalent, which accords with the assumed equivalence of opportunity costs and out-of-pocket costs. For an account of how the scenarios can differ, *see* Steven Shavell, *Specific Performance Versus Damages for Breach of Contract: An Economic Analysis*, 84 Tex L. Rev. 831 (2006).

Observe that if Third Party had offered Seller only $11 per unit, Seller would have chosen to perform, even though Third Party's offer is higher than the contract price. At $11, Seller initially earns $3 per unit. But after paying Buyer $2 per unit in damages, Seller emerges with only $1 net profit, making performance the preferred option. This too is the right result. Third Party's $11 offer does not indicate that Third Party values the goods more than Buyer does. Third Party might, for example, have the same production costs as Buyer's, but be willing to take $1 profit rather than Buyer's $2. Only if Third Party offers more than $12 per unit do we know that Third Party is the more efficient recipient of the goods. More generally, in a contract between A and B, the expectation measure gives A a reason to breach in favor of C's offer only if C's price indicates that C values A's performance more than B values that performance.

Expectation damages also provide the right incentives when the unexpected change involves bad news. Suppose instead of an attractive offer from Third Party, Seller's production costs unexpectedly go up, say as the result of a fire in its factory. Do we still want Seller to produce the goods for Buyer?

If we are concerned only with maximizing social welfare, it depends on the magnitude of the cost increase. Suppose Seller's per-unit costs increase from $8 to $11. The transaction is now a losing one for Seller. Seller will expend $11 to produce a good for which Buyer will pay $10. But the transaction as a whole remains welfare enhancing. With Seller investing $11 and Buyer investing $6, they together spend $17 to generate $18 in value. If, alternatively, Seller's per-unit costs go up to $13, performance is inefficient. Seller and Buyer are together spending $19 per unit to produce $18 in value.

Again the expectation measure gives Seller the right incentives. With no legal remedy, Seller experiences only its own costs of performance or breach. With the expectation remedy, Seller also experiences the costs of breach to Buyer. As a result, Seller will choose performance so long as the transaction as a whole creates value. If Seller's per-unit performance costs go up to $11, Seller loses $1 per unit on performance ($11 costs – $10 contract price). Because breach would cost seller $2 per unit in expectation damages, Seller will choose efficient performance. If Seller's performance costs go up to $13, Seller loses $3 per unit. Now Seller will choose to breach and pay damages.

Adding Buyer reliance does not change the result. Suppose on April 1, when Seller is considering breach, Buyer has invested $200 in preparing its own production facilities, an investment that will be wasted should Seller breach. The social cost of breach now includes destroying the value of Buyer's investment. A sale to Third Party for $13 per unit therefore results in only a $3 per-unit net gain from the transaction ($13 sale price – $8 Seller costs – $2 Buyer lost investment), which is less than the $4 net gain from performance. Again expectation damages get us the right result. Buyer's reliance means that the expectation measure is now $4 per unit ($2 wasted investment + $2 lost profit). Facing those payments, Seller will breach only if Third Party offers to purchase for more than $14 per unit, the point at which Seller's gain from breach equals its gain from performance ($14 price – $8 production costs – $4 damages = $2). This is correct. Only an offer of more than $14 clearly indicates that a sale to Third Party will generate more value than will performance.

Adding a prepayment to the hypothetical also does not change the result. Expectation damages give efficient incentives in all the scenarios for the same

reason: In a contract between A and B, the social gain from A's performance is the sum of A and B's expected profits. If there is no legal remedy, when A decides between performance and breach A considers only its own expected profits. Expectation damages force A to internalize the effect of breach on B's expected profits. The measure thereby forces A to weigh all the welfare effects of performance against all the welfare effects of breach. A will perform when performance creates more value and will breach when breach creates more value. As Robert Cooter and Melvin Eisenberg put the point, "expectation damages place on the promisor the promisee's loss of his share of the contract's value in the event of breach, and thereby sweep that loss into the promisor's calculus of self-interest."[9]

We now have an answer to Fuller and Perdue's puzzle. Only expectation damages give parties efficient incentives. Because neither the reliance nor the restitution measure incorporates the gains of trade, both are typically lower than the expectation measure. Under either, therefore, a self-interested rational party will sometimes breach when performance would be more efficient. Supercompensatory remedies, such as disgorgement or punitive damages, are similarly inefficient. They give a party too much reason to perform and will sometimes result in performance when breach would be more efficient. Only the expectation remedy gives parties an incentive to perform if and only if performance maximizes social welfare.

II. Criticisms from Outside the Model

The efficient breach theory was first introduced by Robert Birmingham in his 1970 article, "Breach of Contract, Damage Measures, and Economic Efficiency," though the theory's influence is due to its promotion in the 1972 first edition of Richard Posner's *Economic Analysis of Law*.[10] By the 1983 publication of the *Restatement (Second) of Contracts*, the theory was widespread enough to receive a tentative endorsement in the Introductory Note to the Remedies chapter.[11] But the drafters also added a caveat:

> [The efficient breach theory's] focus on the pecuniary aspects of breach fails to take account of notions of the sanctity of contract and the resulting moral obligation to honor one's promises. The analysis of breach of contract in purely economic terms assumes an ability to measure value with a certainty that is not often possible in the

[9] Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 Calif. L. Rev. 1432, 1463 (1985).

[10] Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 rutgers l. rev. 273, 284, 288–9 (1970); Posner, Economic Analysis of the Law, §§ 3.8–3.11, 55–61. Douglas Baird has identified efficient breach theory as "Posner's most important contribution in contracts," with no mention of Robert Birmingham's earlier contribution. Douglas G. Baird, Reconstructing Contracts (2013). Birmingham's 1970 article bears reading by anyone interested in contract theory and economic analysis. In addition to introducing the idea of efficient breach, Birmingham discusses the relationship between contract law and nineteenth-century free market thinking, the Scholastic just price theory, and the application of efficient breach to labor contracts.

[11] *Chapter 16: Introductory Note, in* Restatement (Second) of Contracts 99–100 (1983).

> judicial process. The analysis also ignores the "transaction costs" inherent in the bargaining process and in the resolution of disputes, a defect that is especially significant where the amount in controversy is small.[12]

This compressed statement gestures toward two strands of criticism. The first argues that the efficient breach theory is morally problematic, the second that it relies on empirically false assumptions.

The moral criticism begins with the simple theory's apparent celebration of efficient breach. Early advocates wrote that efficient breach should be "encouraged," that when performance is no longer efficient, there should be "an incentive to commit breach," and that "a contractual obligation is not necessarily an obligation to perform, but rather an obligation to choose between performance and compensatory damages."[13] These claims run contrary to common understandings of the moral force of a promise. A promise that is neither disjunctive nor conditional in form is neither disjunctive nor conditional in effect. A contractual promise creates a moral obligation to perform, not an obligation to perform if performance is efficient, or an obligation to perform or pay damages. An efficient breach remains a breach and therefore a wrong, and the law should not be in the business of encouraging wrongful behavior. The efficient breach theory commends acts that the law should condemn.[14]

Nor are the distributive outcomes of efficient breach morally attractive. Efficient breach theorists emphasize that when expectation damages work correctly, the obligee is indifferent between performance and breach. So long as damages put the nonbreaching party in the position she would have occupied had performance occurred,

[12] Restatement (Second) of Contracts, at 100.

[13] Birmingham, *Breach of Contract*, at 284, 288–9; Posner, Economic Analysis of the Law, at 57; Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 Colum. L. Rev. 554, 558 (1977). Other early advocates adopted less charged formulations. John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. Legal Stud. 277, 282 (1972) ("In the situation of changed circumstances, it may well be economically inefficient to complete the transaction. The changes may make the total cost of the transaction greater than the total benefits. Consequently, one is properly chary about requiring the enforcement of what I have called the 'non-market' contract, through injunction or through damages of a form that always induces performance."); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 Mich. L. Rev. 341, 342 (1984) ("The law… should not hinder the breaching of contracts where the breach offers a Pareto-superior outcome.")

[14] *See*, *e.g.*, Douglas Laycock, *Holmes, Posner and Efficient Breach, in* The Death of the Irreparable Injury Rule 245 (1991); Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. legal stud. 1 (1989); Frank Menetrez, Comment, *Consequentialism, Promissory Obligation, and the Theory of Efficient Breach*, 47 U.C.L.A. L. Rev. 859 (2000); Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 Harv. L. Rev. 708, 732–3 (2007). For an ambitious attempt to argue that sophisticated parties do in fact intend their promises to be disjunctive, *see* Daniel Markovits & Alan Schwartz, *The Myth of Efficient Breach: New Defenses of the Expectation Interest*, 97 Va. L. Rev. 1939, 1973–7 (2011); Daniel Markovits & Alan Schwartz, *The Expectation Remedy and the Promissory Basis of Contract*, 45 Suffolk U. L. Rev. 799, 808–12 (2012). For criticisms of Markovits and Schwartz's argument, *see* Gregory Klass, *To Perform or Pay Damages*, 98 Va. L. Rev. 143 (2012); Seana Valentine Shiffrin, *Must I Mean What You Think I* Should *Have Said?*, 98 Va. L. Rev. 159 (2012)..

This criticism of the efficient breach theory should be distinguished from criticisms of expectation damages as insufficiently attuned to parties' moral obligations. Many authors assume or argue that the morality of promising recommends specific performance, disgorgement, or punitive damages for breach. Such claims are not directed at the efficient breach theory as such. I suggests some responses to such criticisms of the expectation remedy in Gregory Klass, *Promise Etc.*, 45 Suffolk U. L. Rev. 695 (2012).

what does it matter if her counterpart chooses to efficiently breach rather than perform? This attitude treats damage payments as an indulgence that washes away the wrong of breach.[15] As such, it misunderstands the function of damage payments. An unexcused failure to perform a promise often produces secondary obligations, such as the duty to apologize or to somehow make it up to the promisee. Damage payments might track or satisfy those obligations. They do not, however, make the wrong of breach go away, even if the promisee is fully compensated. Promissory obligations are about more than ensuring that the promisee achieves a certain level of welfare. They are about trust and moral authority. Post-breach redistribution does nothing to undo the moral wrong of breach.

In fact, the theory's recommended distribution gets things exactly wrong, for it advocates rewarding breach.[16] In the good-news scenario described above, the original contract promised $4 per unit in net gains from performance, $2 profit to Seller and $2 profit to Buyer. Third Party's offer to pay $13 for the goods created the opportunity for the parties to realize between them a $5 per-unit gain ($13 price – $8 Seller costs = $5). If, as the efficient breach theory recommends, Seller breaches, pays expectation damages, and sells the goods to Third Party, Seller pockets the $1 difference ($3 profit vs. $2 profit) and buyer comes out even ($2 expectation damages). If, on the contrary, Seller delivers the goods, Buyer might sell them to Third Party. Now, as compared to the first transaction, Seller comes out even ($2 profit), whereas Buyer receives the extra $1 from the sale to Third Party ($13 resale price – $10 contract price = $3). The theory of efficient breach is morally problematic not only because it encourages a moral wrong, but also because it would allocate all the gains from that wrong to the wrongdoer. The morally optimal remedy for a good-news efficient breach, according to this line of thinking, is disgorgement: return to the nonbreaching party of the Seller's gains from reallocating resources that had been promised to the buyer.[17]

In addition to these moral deficiencies, the simple theory rests on a false picture of the world. To begin with, as the drafters of the Second Restatement suggest, the theory largely ignores transaction costs.[18] The simple theory offers no account of how it is that breaching parties come to pay expectation damages. In the real world, payment often happens only after litigation or private settlement, which consume judicial and party resources that might otherwise be used to increase social

[15] "The indulgence which the preachers proclaim the 'greatest grace' is truly that, insofar as it brings great profit." Martin Luther, 95 Theses, Thesis 67.

[16] I believe this was first noticed in print by Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle*, at 559, 568.

[17] *See* Richard R. W. Brooks, *The Efficient Performance Hypothesis*, 116 Yale L.J. 568, 572–3 (2006); John P. Dawson, *Restitution or Damages?*, 20 Ohio St. L.J. 175, 186–7 (1959); Melvin A. Eisenberg, *The Disgorgement Interest in Contract Law*, 105 Mich. L. Rev. 559, 578–81 (2006); Daniel Friedmann, *Restitution of Benefits Obtained through the Appropriation of Property or the Commission of a Wrong*, 80 Colum. L. Rev. 504, 513–27 (1980).

[18] This paragraph barely scratches the surface of the many sorts of transaction costs that are involved in enforcing contracts. For a richer descriptive account, *see* A. A. Leff, *Injury, Ignorance, and Spite—The Dynamics of Coercive Collection*, 80 Yale L.J. 1 (1970). *See also* Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 Va. L. Rev. 1443 (1980) (emphasizing both transaction costs and uncertainty of recovery).

welfare. Because litigation and settlement costs are deadweight losses, they can render an otherwise efficient breach socially inefficient. Litigation and settlement costs can also destroy the efficient incentives expectation damages would otherwise create. Depending on how the costs are allocated, they can result in undercompensation for nonbreaching parties and overdeterrence (from an efficiency perspective) of prospective breachers. Finally, litigation and settlement costs sometimes deter the victims of breach from even filing a lawsuit. Though efficient breach theory assumes that the obligee is indifferent between performance and breach, we know from experience that this is rarely the case.

The simple theory also unrealistically assumes perfect information. In the actual world, meritorious lawsuits sometimes fail due to lack of evidence or mistakes of judgment. And even where there is a finding of breach, a monetary award might not match actual losses. The plaintiff's burden of proof and legal rules that limit recovery mean that damage awards are systematically undercompensatory.[19] Nor do parties have the knowledge that the simple theory requires of them. In the above example, to know whether performance is efficient or in its interest, Seller must know both Buyer's present investment in the transaction and Buyer's expected profits from performance. In the actual world, one party rarely knows what its breach will cost the other. The efficient breach theory assumes transparency in an opaque world.[20]

Finally, the simple theory employs a false picture of how contracting parties decide between performance and breach. First, the theory assumes that parties are perfectly rational, or at least rational on average. Cognitive science and behavioral economics have demonstrated that even sophisticated parties can be systematically irrational. If this is so, we cannot be sure that even if the expectation remedy creates efficient incentives, parties will respond to them as the theory predicts.

Second, the simple theory assumes that the threat of legal liability is the only reason to perform. Opportunities for repeat play and reputational effects can give even an amoral self-interested rational utility maximizer nonlegal reasons to perform. A party who expects that she might have a long-term opportunity to transact with her counterpart again might not want to sacrifice it for a short-term gain from breach. And a party who regularly engages in similar transactions with others might worry about the reputational costs of breach.[21] Nor should we accept the premise that parties are purely self-interested. Many contracting parties have other-regarding preferences. Whether these come from friendship, moral responsiveness, a sense of honor, or somewhere else, such preferences provide additional reasons to perform. Only by assuming away such reasons can the

[19] *See*, *e.g.*, Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 Yale L.J. 1261, 1288–91 (1980).

[20] The costs of observing the nonbreaching party's expectation interest are rarely emphasized in the literature. An exception is Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 93 Calif. L. Rev. 975, 1000, 1015 (2005); Eisenberg, *The Disgorgement Interest in Contract Law*, at 572. *See also* Barton, *The Economic Basis of Damages for Breach of Contract*, at 282 (mentioning that the efficient breach model "assumes a rather complete knowledge by the parties of each other's utilities… seldom warranted in practice").

[21] *See* Goetz & Scott, *Enforcing Promises*, at 1289 ("[A]n optimal legal sanction may also include a discount for the effects of extra-legal factors—such as reputational losses or social restraints on breach—that independently reward the performing promisor for taking into account some of the social effects of promising.").

simple breach theory conclude that expectation damages perfectly calibrate a party's reasons to perform.[22]

There are therefore two problems with the simple theory of efficient breach, one normative and the other descriptive. The theory judges whether breach is desirable and what the consequences of breach should be in ways that cannot be squared with common understandings of the parties' moral obligations. And the theory gets its results only by assuming away facts that we know to be true of most parties, most contractual transactions, and most contract disputes.

III. Criticisms from within the Model

The above common criticisms are, I think, enough to reject the simple theory of efficient breach as a complete explanation or sufficient justification of the common law's apparent attachment to expectation damages. The question is whether those criticisms aim at a theory worth criticizing. Although the simple theory enjoys some sway in the legal imagination, no serious economic thinker today propounds it. In fact, as soon as the simple theory appeared, economically oriented scholars working within the same neoclassical and welfarist model began raising significant questions about it. Over 40 years later, it is clear that even granting the assumptions of neoclassical economics, the simple theory simplifies much too much. It fails to recognize that some breaches are not only inefficient, but opportunistic. It does not provide a defense of expectation damages as against other possibly equally efficient remedies. It focuses on the single perform-or-breach decision, when in fact remedial rules provide incentives to act more or less efficiently across the whole of a transaction. And it ignores other functions remedies serve, such as risk allocation and signaling.

Even within the simplifying assumption of the model, expectation damages are a second-best tool for welfare maximization. In a first-best world, parties would enter into efficient complete contingent contracts. A complete contingent contract anticipates every contingency that might affect the desirability of performance and instructs the parties what to do in those circumstances.[23] An efficient complete contingent contract between Seller and Buyer, for example, would stipulate that if a third party offers

[22] For some initial attempts to make the empirical case specific to contract, *see* Tess Wilkinson-Ryan & David A. Hoffman, *Breach is for Suckers*, 63 Vand. L. Rev. 1001 (2010); Tess Wilkinson-Ryan, *Do Liquidated Damages Encourage Breach? A Psychological Experiment*, 108 Mich. L. Rev. 633 (2010); Daphna Lewinsohn-Zamir, *The Questionable Efficiency of the Efficient-Breach Doctrine*, 168 J. Institutional & Theoretical Econ. 5 (2012).

[23] *See* Steven Shavell, *Damage Measures for Breach of Contract*, 11 Bell J. Econ. 466, 468 (1980) ("[A] damage measure for breach of contract may create incentives for parties who have made a contract which does not provide for various contingencies to act in a way that is close to (and in the example is actually identical to) what they would have agreed upon under a Pareto efficient complete contingent contract"); *see also* Barton, *The Economic Basis of Damages for Breach of Contract*, at 283–7 (anticipating Shavell's notion of a complete contingent contract); Steven Shavell, *On the Design of Contracts and Remedies for Breach*, 99 Q. J. Econ. 121, 147 (1984) (further elaborating the idea). George Triantis has recently argued that many contracts are partly complete. "Real-world contracts, of course, are not complete. However, they may 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." George G. Triantis, *The Evolution of Contract Remedies (and Why Do Contracts Professors Teach Remedies First?)*, 60 U. Toronto L.J. 643, 646 (2010).

more than $12 per unit for the goods or if Seller's production increases to over $12 per unit, Seller shall be excused from delivery. Depending on the parties' risk preferences, the contract might also require that in that event Seller pay money to Buyer. In short, a complete contingent contract describes all of the circumstances in which performance is efficient and imposes a duty to perform in and only in those circumstances. Because the breach of such a contract is by definition inefficient, it should not be priced but punished. If parties were able to write complete contingent contracts *ex ante*, or if courts were able to construe them *ex post*, there would be no need to "encourage" efficient breach. Efficient breach would not exist.[24]

Although complete contingent contracts are a theoretical fiction, it is often possible to say with certainty that one or another breach is inefficient. A breach is opportunistic when one party attempts to reap "the benefit of the bargain without bearing the agreed-upon cost."[25] Suppose in the above hypothetical that Seller delivers the goods as promised, Buyer uses them to make and sell its own product, and Buyer then refuses to pay Seller the price. In the model, Buyer's breach is not even arguably efficient. It does not shift productive resources to a more valuable use, but merely alters the distribution of wealth. In fact, if unremediated the breach will impose social costs. Future sellers will be less likely to extend credit to buyers, reducing the number of value-creating transactions; those who do sell on credit will invest in value-sucking precautions to ensure payment. The efficient breach theory provides no argument against punishing such opportunistic breaches. As Posner puts the point in later editions of *Economic Analysis of Law*, "[i]f a promisor breaks his promise merely to take advantage of the vulnerability of the promisee… we might as well throw the book at [him]."[26] Even on the premises of the simple theory, some breaches are beyond the pale.

All of this is of a piece with the familiar economic claims about when the law should attempt to prevent wrongful behavior and when it should put a price on it. As Robert Cooter has formulated the point:

> If lawmakers can identify socially desirable behavior, but are prone to error in assessing the cost of deviations from it, then sanctions [that provide full deterrence] are preferable to prices. However, if officials can accurately measure the external cost of behavior, but cannot accurately identify the socially desirable level of it, then prices are preferable to sanctions.[27]

There exist whole categories of breach that are always opportunistic or otherwise inefficient. From a purely welfarist perspective, the socially optimal level of such behavior

[24] If parties could write efficient complete contingent contracts they would do so, since such contracts maximize the potential gains of trade. I discuss this point further in Section IV.

[25] *Patton v. Mid-Continent Sys., Inc.*, 841 F.2d 742, 751 (7th Cir. 1988) (Posner, J.).

[26] Richard A. Posner, Economic Analysis of Law 105 (3d ed., 1986). For extended discussions of opportunistic breach, *see* Richard Craswell, *When is a Willful Breach "Willful"?: The Link between Definitions and Damages*, 107 Mich. L. Rev. 1501 (2009); William Dodge, *The Case for Punitive Damages in Contracts*, 48 Duke L.J. 629, 654–62 (1999).

[27] Robert Cooter, *Prices and Sanctions*, 84 Colum. L. Rev. 1523, 1524 (1984); *see also* Guido Calabresi & Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972).

is zero. Bad faith breach of an insurance contract is a well-known example. An insurer who knowingly denies or delays payment of a valid claim is not shifting resources to more valuable uses, but simply taking an unbargained-for piece of the pie.[28] And on the model, extracompensatory remedies might be necessary to provide an incentive to perform. Or consider duties designed to make it easier for one party to recover for the other's breach, such as the duty to keep records, to share information about performance, or to permit audits. Because such terms are designed to ensure payment for breach of the underlying duty, their breach is rarely efficient.[29] Economic theory recommends punishing rather than pricing such opportunistic breaches.

But that is not all. Even if we restrict ourselves to efficient breaches of incomplete contracts, the simple theory fails to show that only expectation damages will do. The simple theory demonstrates at most that expectation damages are one way to incentivize efficient performance decisions. It does not show that expectation damages are the only way to do so.

The problem is Coase. The Coase Theorem says that if legal entitlements can be cheaply traded, then who gets them in the first instance does not affect their ultimate allocation, which will always be efficient.[30] Entitlements assigned to low-value holders will be traded up to higher-value holders because higher-value holders will be willing to pay more for them. The initial assignment has distributive effects, but does not affect allocative efficiency. It affects who gets how much, but the entitlement eventually ends up where it creates the most value.

The simple theory of efficient breach does not consider the possibility of post-contractual Coasian bargains. Suppose courts award specific performance wherever practicable and Buyer sues as soon as Seller indicates an intent to breach.[31] In the good-news scenario above, Seller no longer has the option to breach, sell the goods to Third Party for $13 per unit, and pay Buyer $2 per unit expectation damages. It does not follow, however, that Seller will perform. Third Party's offer gives Seller and Buyer the opportunity to jointly gain $1 per unit, or $100 total, from nonperformance. If Seller is rational, it will offer to pay Buyer to release it from the contract. Buyer, who stands to net $200 from performance, will demand at least $201 for the release. Seller, who can earn up to $300 more from selling to Third Party ($1,300 offer price – $1,000 contract price), will not pay more than $299. The simplest solution is a $250 payment, which splits the gains from nonperformance. Seller sells to Third Party for $1,300, pays Buyer $250, and ends up netting $250 after its own production costs. Each party comes out $50 ahead as compared to performance.

Specific performance plus renegotiation provide a similarly efficient result in the bad-news scenario. If Seller's costs jump to $13 per unit, Seller stands to lose $300 on

[28] *See* Nicholas J. Johnson, *The Boundaries of Extracompensatory Relief for Abusive Breach of Contract*, 33 Conn. L. Rev. 181, 187–8 (2000); Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions after Two Decades*, 37 Ariz. L. Rev. 1153 (1995).

[29] *See* Gregory Klass, *Contracting for Cooperation in Recovery*, 117 Yale L.J. 2 (2007).

[30] R. H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960).

[31] *See* Alan Schwartz, *The Case for Specific Performance*, 89 Yale L.J. 271 (1979). The basic idea was identified by Robert Birmingham a year before he introduced the theory of efficient breach. Robert L. Birmingham, *Damage Measures and Economic Rationality: The Geometry of Contract Law*, 1969 Duke L.J. 49, 70 (1969).

performance ($1,300 cost – $1,000 contract price), and so will be willing to pay Buyer up to $299 for the release. Again Buyer will grant the release for a payment of $201 or more. Because the parties can bargain to a mutually beneficial exit price, inefficient performance will not happen. As in the good-news scenario, the parties end up sharing the gains from breach, though now Seller's gains take the form of losses avoided.

Once we allow for the possibility of post-contractual Coasian bargains, other remedies become equally plausible. Suppose courts impose punitive damages for any willful breach. So long as paying the punitive damage award costs Seller more than Seller's benefit from breach, Seller would rather perform than pay damages, even if performance is inefficient. But again there is a third option: Seller can offer to purchase Buyer's release. Buyer now prefers breach plus recovery to performance. But when negotiating for a release Seller can credibly threaten to perform, making payment for the release Buyer's preferred alternative. Again we can expect the parties to arrive at an exit price that benefits both relative to inefficient performance.[32]

We even get efficient outcomes with subcompensatory remedies. Suppose the remedy is reliance damages and that Buyer has not yet invested anything in the transaction when Third Party offers Seller $11 per unit. At that price, we cannot be sure whether breach is efficient, and because the reliance measure gives us a damage payment of zero, we might worry that Seller will take the higher offer. But faced with the threat of breach, Buyer can offer to pay Seller something more to perform. Because Buyer stands to gain $200 from performance at the original price and nothing from breach, Buyer will be willing to pay up to $199 more to secure performance. Seller, who stands to earn an additional $100 from the sale to Third Party, will demand an additional payment of at least $101. Again, so long as post-contract renegotiation is possible, the remedy gets us the right outcome.

If this last result seems odd, that is partly due to the exclusive focus on the perform-or-breach decision.[33] Even if subcompensatory remedies, or no remedies at all, are compatible with efficient performance decisions, it is not obvious that they give parties enough reason to enter into contracts in the first place. I return to this issue later in this section. For the moment, the point is merely that in the frictionless model the simple theory occupies, all remedies are created equal. To show that expectation damages are the *more efficient* remedy, we need to add transaction costs to the model. The real question is which remedy provides an efficient outcome at the lowest cost.

Economically oriented legal scholars have not ignored transaction costs. Something approaching a consensus view has emerged about the variables that matter in the choice between, on the one hand, remedies that attempt to incentivize efficient unilateral performance decisions, such as expectation damages, and on the other, remedies

[32] William Dodge has argued the efficiency of punitive damages for all willful breaches. Dodge, *The Case for Punitive Damages in Contracts*, at 663–87. For a parallel argument applied to party-specified penalties, *see* Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle*, at 567. For a thorough discussion of how and when parties might threaten inefficient performance, *see* Ian Ayres & Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. Pa. L. Rev. 45 (1999).

[33] Another reason it is odd is that the Coase theorem assumes that Coasian bargains are always performed. The theorem therefore assumes a solution to a problem that contract law is designed to solve. That, however, is a topic for another forum.

that rely on post-contractual Coasian bargaining.[34] The principle cost of expectation damages is determining the nonbreaching party's losses in the case of nonperformance, that is, the magnitude of its expectation interest. This cost is borne first by the party deciding between performance and breach, and later, if the issue goes to litigation, by parties and the courts.[35] Coasian bargains avoid those measurement costs. In post-contractual negotiations, each party uses what it already knows about its own interests to arrive together at a mutually beneficial exit price. But those negotiations can themselves be costly. Parties to a contract find themselves in a bilateral monopoly: each is negotiating for a benefit it can only get from the other side, and each is likely to be ignorant of the other's reserve price. With no outside alternatives, the parties might expend considerable resources haggling over an exit price. Those negotiation costs are deadweight losses, and might even prevent the parties from reaching a deal.[36]

Even if Coasian bargains are too expensive or impracticable, there are yet other efficient options within the model. The efficient breach theory recommends giving the obligor, Seller in the above example, the choice to breach and pay damages. This is effectively a call option: Seller has the ability to purchase nonperformance for a price. It might be equally efficient to give the obligee something like a put option.[37] On this approach, Seller would have an absolute obligation to perform, enforced by specific performance, penalties, or the like, and Buyer would have the unilateral power to cancel the contract and collect from Seller some or all of Seller's potential gains from nonperformance. Now if Seller gets an offer from Third Party, Buyer can decide whether performance happens. Buyer will choose to exercise its option to cancel only if Third Party's price is high enough that Seller will pay Buyer more than Buyer would receive from performance. If Third Party offers $11 per unit, Buyer will not exercise the put. Seller's gains from nonperformance, $1 per unit, are less than Buyer's gains from performance. If Third Party offers $13 per unit, Buyer will exercise the option so long as it can extract at least $2 of the higher price. Again, from an efficiency perspective, the choice turns on transaction costs. If the goal is to have one or another side make an efficient unilateral performance decision, the question is who is the cheapest inefficiency avoider.[38] This depends in part on which party is in a better position to seek out third-party offers or other wealth-creating alternatives to performance. It also depends on relative measurement costs. Giving Buyer a put option means that we

[34] For a basic introduction, *see Walgreen Co. v. Sara Creek Prop. Co.*, 966 F.2d 273 (7th Cir. 1992) (Posner, J.).

[35] Most writers on efficient breach emphasize only the latter, the costs of post-breach damage determinations. This is odd, since there's little reason to expect parties to know one another's cost functions. There is no reason to expect one party to be able to observe the other's expectation interest, though that knowledge is essential to the efficient breach story.

[36] *See* Robert Cooter, *The Cost of Coase*, 11 J. Legal Stud. 1, 16–20 (1982). For other costs associated with Coasian bargaining, *see* Markovits & Schwartz, *The Myth of Efficient Breach*, at 1973–7.

[37] *See* Brooks, *The Efficient Performance Hypothesis*; Ian Ayres, Optional Law: The Structure of Legal Entitlements (2005). *See also* Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle*, at 559 (suggesting that the law need not allow the breaching party to keep all the gains of breach).

[38] *See* Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. Cal. L. Rev. 629, 660 (1988).

avoid the costs of having Seller or a court figure out Buyer's expectation interest, but it adds the expense of measuring Seller's possible gains from nonperformance.

Though we have arrived at some fairly esoteric proposals, the above survey does not exhaust proposed efficient alternatives to expectation damages.[39] But it is enough to show the variety of remedies that can be efficient within the frictionless world of the simple theory. With respect to efficiency, the choice between remedial rules depends on their relative transaction costs. There is now a large theoretical literature on the relative transaction costs of different remedial schemes. That literature has not, however, converged on a single answer. As Ian Macneil observed over 30 years ago, "it is extremely easy to introduce selected transaction costs to show that the model 'proves' what the modeler wants it to prove, while ignoring countless other transaction costs of equal or greater pertinence in the real world—yielding different conclusions."[40] The question itself is at bottom an empirical one, for which we have very limited data.[41] Nor is there a reason to expect the same answer for all transactions. Different transaction types generate different types of transaction costs. A complete theory of efficient breach would provide an empirically grounded account of when and why expectation damages provide the cheapest route to an efficient performance decision. The simple theory does not.

A third internal criticism of the simple theory concerns its narrow focus on the choice between performance and breach. Remedial rules influence many decisions at various stages of a transaction. The simple theory's attention only to achieving efficient incentives to perform or breach risks providing inefficient incentives elsewhere in the transaction.

The point is made most easily with respect to the obligee's reliance decision. Recall again the January 1 contract between Seller and Buyer, in which Buyer is to pay $1,000 for goods delivered in July, which Buyer will then invest $600 in and resell for $1,800. Suppose now that Buyer has a choice: it can invest $200 in equipment in January and

[39] Another possibility is nested options. *See* Ian Ayres & J. M. Balkin, *Legal Entitlements as Auctions: Property Rules, Liability Rules and Beyond*, 106 Yale L.J. 703 (1996). Barry Adler has argued that on the efficient breach model, there is a case to be made for "negative damages," paid by the nonbreaching party to the breaching party, when the nonbreaching party benefits from breach. *Efficient Breach Theory through the Looking Glass*, 83 N.Y.U. L. Rev. 1679 (2008). I have suggested specific performance plus giving the obligor an option to avoid performance by voluntarily paying a price. Klass, *To Perform or Pay Damages*, at 147–8. Even tortious interference has been proposed as an efficient rule, on the theory that in a good-news scenario it requires fewer transactions to get to an efficient allocation. Fred S. McChesney, *Tortious Interference with Contract Versus "Efficient" Breach: Theory and Empirical Evidence*, 28 J. Legal Stud. 131, 148–56 (1999).

[40] Ian Macneil in *Efficient Breach of Contract: Circles in the Sky*, 68 Va. L. Rev. 947, 961 (1982); *see generally* at 951–7. For a recent example of what I consider a selective accounting transaction costs, see Markovits & Schwartz, *The Myth of Efficient Breach*, at 1973–7. Markovits and Schwartz do not explain why they include some transaction costs ("relax some of the model's assumptions," at 1973) in their analysis but not others.

[41] *See* Paul G. Mahoney, *Contract Remedies and Options Pricing*, 24 J. Legal Stud. 139, 142 (1995) (arguing that a transaction cost approach "yields… no persuasive conclusion when transaction costs are low (unless we can measure them with extreme precision)"); Eric A. Posner, *Economic Analysis of Contract Law after Three Decades: Success or Failure?*, 112 Yale L.J. 829 *passim* (2003); Schwartz, *The Case for Specific Performance*, at 294 ("On the basis of information currently available, it is impossible to say whether [specific performance's efficiency] gains would exceed the increase in administrative and judicial opportunity costs that the availability of specific performance would engender.").

shave $40 off its total costs, or it can buy the same equipment after Seller delivers the goods and expend the full $600 to improve and resell the goods. If Seller is certain to perform, the value-maximizing choice is to buy the equipment in January. By spending $200 six months early, Buyer nets an extra $40. But suppose there is a 20 percent chance that Seller will efficiently breach, in which case Buyer's $200 January investment will be wasted. We can now express the risk-adjusted value of Buyer's early investment as follows:

$$V = (.8)(\$40\,\text{gain}) + (.2)(\$200\,\text{loss}) = \$32 - \$40 = -\$8$$

Under these circumstances it is better for Buyer to wait until performance is certain before relying. By relying early, Buyer risks sunk costs that produce no value. But this is not the result we get with the expectation remedy. Because expectation damages fully insure Buyer against nonperformance, including its reliance costs, Buyer will invest as if Seller's performance is certain and purchase the $200 equipment in February.[42]

One example does not prove the rule, but it illustrates the moral hazard expectation damages create. Steven Shavell and others have used formal models to show that "[t]here does not exist a damage measure which leads to Pareto efficient decisions concerning both breach and reliance independent of the type of contractual situation."[43] Optimally incentivizing A's performance often means giving B the wrong incentives with respect to reliance. Similarly, giving B an incentive to rely efficiently can mean providing A suboptimal incentives with respect to performance. Where the simple theory lavishes all its attention on the one variable, efficiency requires attending to at least two.

In fact, it requires attending to many variables at once. In the past 40 years, economically oriented scholars have identified many other overlapping decisions remedial rules can affect. These include the number of transactions,[44] potential promisors' pre-formation investigations,[45] the selection of contracting partners,[46] quantity terms,[47] post-formation search for other opportunities,[48] post-formation reliance by the obligee,[49] precautions against one's own breach,[50] and post-breach mitigation by the nonbreaching party.[51] No single remedial rule is likely to provide optimal incentives

[42] *See* Shavell, *Damage Measures*, at 478 ("[U]nder the expectation measure the buyer is in effect guaranteed his expectancy, and hence he sees reliance as an investment with a certain payoff. Therefore, he engages in reliance up to the point where its marginal product conditional on performance is driven down to one.").

[43] Shavell, *Damage Measures*, at 472; *see also* Robert Cooter, *Unity in Tort, Contract and Property: The Model of Precaution*, 73 Calif. L. Rev. 1 (1985); Lewis A. Kornhauser, *Reliance, Reputation and Breach of Contract*, 26 J.L. & Econ. 691 (1983).

[44] David Friedman, *An Economic Analysis of Alternate Damage Rules for Breach of Contract*, 32 J.L. & Econ. 281 (1989); Goetz & Scott, *Enforcing Promises*, at 1283.

[45] Richard Craswell, *Precontractual Investigation as an Optimal Precaution Problem*, 17 J. legal stud. 401 (1988).

[46] Craswell, *Contract Remedies*, at 650.

[47] Barton, *The Economic Basis of Damages for Breach of Contract*, at 293–300.

[48] Peter A. Diamond & Eric Maskin, *An Equilibrium Analysis of Search and Breach of Contract, I: Steady States*, 10 bell j. econ. 282 *passim* (1979).

[49] *See* note 42.

[50] Craswell, *Contract Remedies*, at 645–50.

[51] Craswell, *Contract Remedies*, at 657.

across these many decisions. More to the point, as Richard Craswell has argued, there is "no reason to suppose that the totality of economic effects will always favor an award of expectation damages."[52] More likely is "some hybrid or intermediate number."[53] Efficiency-minded theories must balance and satisfice, seeking out the remedy that, in combination with other rules, creates the most value across the lifetime of a transaction.

Finally, the simple theory paints too simple a picture of what remedies do. According to the simple theory, the legal remedy for breach serves only to create efficient incentives. Even within the neoclassical model, remedies can serve several other functions as well. By ignoring them, the simple theory again simplifies too much.

Most obviously, contract remedies also serve to allocate risk. Generally speaking, parties enter into contracts for two sorts of reasons: to give one or both a new reason to perform and to shift risk among them. In some contracts, the incentive to perform looms larger. Think of a homeowner's contract with a builder to renovate a kitchen. It is true that the homeowner wants to recover damages should the builder walk off the job. But what she really wants is a new kitchen. The homeowner wants a contract primarily because she hopes that the threat of legal liability for breach will give the builder a new reason to perform. In other contracts, risk allocation is the more salient function. Insurance contracts are an obvious example. Because the insured is risk averse, it is willing to pay a premium to shift risks of loss to the insurer. Or consider forward contracts among nonproducers in a thick market. A contract to sell a commodity at a specified price two years hence allocates the risk of price shifts. The buyer avoids the risk that the spot price will be above the contract price, the seller the risk that the spot price will be below it. There is no such thing as an efficient breach of a pure risk-shifting contract. The goal in allocating risk is not to move resources to a more productive use, but to satisfy each party's risk preferences. Satisfaction requires strict enforcement of the agreed-upon allocation with specific performance or simple market damages.[54]

Both contract terms and contract remedies can function to allocate risk. In a forward contract, the price term allocates the risk of price changes. In the example kitchen-renovation contract, though not its primary function, the remedy insures the homeowner against the risk of the builder's nonperformance. More generally, because contract remedies almost always redound to the benefit of the nonbreaching party, they serve not only to incentivize performance, but also to allocate the risk of nonperformance.

[52] Richard Craswell, *Against Fuller and Perdue*, 67 U. Chi. L. Rev. 99, 109 (2000).

[53] Craswell, *Against Fuller and Perdue*, at 110. Many authors have made similar points. *See*, *e.g.*, Robert Birmingham, *Notes on the Reliance Interest*, 60 Wash. L. Rev. 217, 260–1 (1985); Cooter & Eisenberg, *Damages for Breach of Contract*, at 1462; Craswell, *Contract Remedies*, at 660–1; Craswell, *Two Economic Theories of Enforcing Promises*, at 28–32; Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 Chi.-Kent L. Rev. 33, 52–3 (2003); Avery Katz, *Reflections on Fuller and Perdue's The Reliance Interest in Contract Damages: A Positive Economic Framework*, 21 U. Mich. J.L. Reform 541, 558–9 (1988); Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. Colo. L. Rev. 683, 706 (1986); Posner, *Economic Analysis of Contract Law*, at 834–8; Samuel A. Rea, Jr., *Nonpecuniary Loss and Breach of Contract*, 11 J. Legal Stud. 35, 36 (1982); Robert E. Scott & George G. Triantis, *Embedded Options and the Case against Compensation in Contract Law*, 104 Colum. L. Rev. 1428, 1447–52 (2004).

[54] *See* Barton, *The Economic Basis of Damages for Breach of Contract*, at 277–9; Scott & Triantis, *Embedded Options*, at 1466, 1479–80.

Because different parties have different attitudes towards risk, this risk-allocation function further complicates the efficient breach story. To return again to the example, if Buyer is risk averse and Seller is risk neutral or risk preferring, expectation damages properly allocate the risk of nonperformance by shifting it from Buyer to Seller. In the model, Buyer knows it will get its $2 per-unit profit no matter what happens. Seller both bears the risk of loss in bad-news scenarios and enjoys the risk of an upside gain in good-news scenarios. More generally, expectation damages shift the risk of nonperformance to the breaching party.[55] In a frictionless world, they assure that the party who is owed a duty will occupy the same position whether the duty is performed or breached.

If, however, it is Seller who is risk averse and Buyer who is risk neutral or risk preferring, expectation damages provide the wrong allocation of risk. Suppose Seller has a nonlegal incentive, such as an interest in maintaining its reputation, to perform and that the only function of a damage payment is to allocate risk. Suppose further that the parties are especially worried about bad-news scenarios, in which Seller's out-of-pocket costs unexpectedly go up. If Seller is risk averse and Buyer risk neutral or preferring, setting damages at zero might achieve the optimal allocation of the risk.[56] In case Seller's costs go up, Seller can minimize its losses by choosing not to perform, coming out as close as possible to its original expectation. Buyer, of course, will suffer by getting neither the profits it expected nor payment for its lost expectation, or even reliance, costs. Buyer bears the risk of a bad-news scenario. But Buyer will have benefited *ex ante* in the form of a lower contract price. Think of reduction in the contract price as an insurance premium Seller pays Buyer to bear some or all of the risk of Seller's nonperformance.

There is much more one might say about how remedies can be used to shift risk between parties who have one or another combination of risk preferences. But the example demonstrates the problem for the simple theory. If we now drop the assumption that Seller has nonlegal reasons to perform, the remedy for breach serves two functions at once. It serves to incentivize performance and to allocate risk. The problem is that there is no reason to expect the remedy that provides the optimal incentives also to optimally allocate the risk of breach.[57]

[55] *See* Shavell, *Damage Measures*, at 488.

[56] *See* Kornhauser, *Reliance, Reputation and Breach of Contract*, at 701. In fact, if incentives are truly beside the point, the optimal allocation might be a reverse damage payment, in which Buyer fully insures Seller against Seller's own breach.

[57] The first article to make the case for a possible divergence between efficient incentives and the risk-shifting function of contract remedies was Barton, *The Economic Basis of Damages for Breach of Contract*, at 293–300 (identifying "differences between the optimum-allocation and the incentive-maintenance approaches"). A systematic examination of the efficient allocation of risk through remedies can be found in A. Mitchell Polinsky, *Risk Sharing through Breach of Contract Remedies*, 12 J. Legal Stud. 427 (1983); *see also* Jeffrey M. Perloff, *Breach of Contract and the Foreseeability Doctrine of* Hadley v. Baxendale, 10 J. Legal Stud. 39 (1981) (examining the efficiency of *Hadley* and its alternatives for various party risk preferences); Rea, *Nonpecuniary Loss and Breach of Contract*, at 37 ("The theory of optimal insurance suggests that nonpecuniary losses should not necessarily be compensated, but lack of such compensation may affect the seller's incentive to honor the contract."); Scott & Triantis, *Embedded Options* (arguing that damages are better viewed as option prices utilized to shift risk between the parties, and that such prices bear no relationship to compensation); Shavell, *Damage Measures*, at 487–8 (noting that "in most contractual relationships, both the allocation of risk and the allocation of resources will need to be considered with respect to the role of damage measures").

Incentives and risk allocation are not the only functions remedies serve in economic models. Richard Posner long ago observed that penalty clauses can perform a positive signaling function.[58] New entrants in a market, for example, might find themselves disadvantaged against established participants with reputations for performing. A lower cost new entrant who is a reliable contracting partner can signal its reliability by agreeing to a penalty for breach. The penalty might deter some efficient breaches. But if it makes a value-creating transaction possible, the result can be a net gain. Or consider Paul Mahoney's argument that in the sale of unique goods or in auctions, specific performance serves to assure buyers that the sale is final.[59] Without specific performance, a seller might use a bid simply to elicit information, or might keep looking for higher offers. Knowing that, potential buyers will be less likely to bid to their reserve price. The buyer can always wait for the seller to make a contract with another, then make a higher offer herself. Sellers can avoid this unattractive result by binding themselves to the mast with specific performance, thereby credibly communicating that the bidding deadline is real. Even if the remedy were to deter some efficient breaches, there might again be a net gain, here by eliciting correct prices and reducing transaction costs.

In short, the simple theory's exclusive emphasis on incentivizing the perform-breach decision ignores not only incentive effects elsewhere in the transaction, but also other functions remedies can serve within the model. These gaps in the theory, together with the simple theory's inattention to nonefficient breaches and uncertainty about the transaction costs that attach to different remedies, make it difficult to disagree with Eric Posner's conclusion that efficiency alone "does not explain why expectation damages are the standard remedy."[60]

IV. A More Interesting Theory of Efficient Breach

The simple theory neither explains nor justifies the common law's apparent attachment to expectation damages. Viewed from within the neoclassical economic model it occupies, the theory is radically incomplete. Viewed from outside that model, the theory rests on empirically questionable assumptions and for many is morally unsatisfactory.

But contract theorists should not ignore efficient breach theory. Early proponents presented the theory as a policy argument for expectation damages and a solution to Fuller and Perdue's puzzle. The theory is inadequate to that task. A revised, more sophisticated theory, however, reveals important features of contract remedies. This revised theory is not a policy argument for or defense of existing uses of the expectation measure. Instead, it constructs a stripped down, idealized model to identify

[58] Posner first makes this point in the second edition of his book. Richard Posner, Economic Analysis of the Law 93–4 (2d ed., 1977).

[59] Mahoney, *Contract Remedies and Options Pricing*, at 155.

[60] Posner, *Economic Analysis of Contract Law*, at 880; *see also* Richard R. W. Brooks, *What Efficiency Demands: The Efficient Performance Hypothesis Defended*, 117 Yale L.J. Pocket Part 14, 20 (2007), <http://yalelawjournal.org/images/pdfs/578.pdf> ("Any tie-breaker must be an empirical one. I am deeply skeptical of our capacity and willingness to search out that empirical answer.").

several features of contract remedies that too often escape notice. The revised theory is comparable to the prisoner's dilemma in game theory, to trolley problems in moral philosophy, or to brains in vats in theories of reference. It is a theoretical construct that isolates for analysis phenomena that exist in the world but can be difficult to disentangle from other facts or factors. Isolating these phenomena serves to dispel some common mistakes about contract remedies and to clarify a few basic questions that any adequate theory of contract law must answer.

The revised theory operates within the simplifying model of neoclassical economics but makes three changes to the simple theory. First, it observes that remedies for breach are likely to affect other terms parties choose. In particular, they are likely to affect how the parties allocate the gains of trade. Suppose when negotiating their contract, Seller and Buyer must choose between two remedies for Seller's breach: expectation damages and specific performance. Keeping for the moment the simplifying assumption of no transaction costs, the two remedies are equally efficient. But they have different *ex post* distributive consequences. All else being equal, Seller prefers expectation damages, which allow it to keep all of the gains from nonperformance, whereas Buyer prefers specific performance, which gives Buyer a chance to appropriate some of those gains by forcing Seller to buy a release. In negotiating the remedy, Seller and Buyer will each demand concessions to give up its preferred choice. For simplicity's sake, suppose Seller and Buyer know there is a 10 percent chance that a third party will offer Seller more than $12 per unit, and that on average such an offer will be for $14. In the sale of 100 units, there is therefore a 10 percent chance of an average $200 gain to the parties from nonperformance. If the remedy is expectation damages, Seller gets to keep that entire gain for itself, for a risk-adjusted benefit of $20 ($200 average gain $\times$ 0.1 probability). If the remedy is specific performance, the parties will negotiate a release. Suppose the parties expect that any such negotiations will result in an even split. Seller and Buyer will in that case each realize on average $100 from efficient nonperformance (half the $200 total), for a risk-adjusted present benefit of $10 each ($100 average gain $\times$ 0.1 probability). At the time of formation, therefore, Seller will demand at least, and Buyer will be willing to pay at most, $10 extra for a contract that includes the specific performance remedy rather than expectation damages. The price takes account of the remedy.

In competitive markets we can expect the same price effect even if parties do not have the power to choose the remedy. If Seller knows in advance that the remedy is specific performance, rather than expectation damages, Seller will charge a somewhat higher price for the goods. That increase in price will correspond to the increased costs to Seller in the case of Seller's nonperformance, discounted by the probability of its nonperformance. As Robert Cooter and Melvin Eisenberg put the point, "the exchange of legal rights is no different than the exchange of ordinary commodities."[61]

[61] Cooter & Eisenberg, *Damages for Breach of Contract*, at 1461. Scholars have long recognized the effect of remedial rules on price. Before the idea of efficient breach had entered the literature, Richard Hartzler made the point in his analysis of Fuller and Perdue's categories. H. Richard Hartzler, *The Business and Economic Functions of the Law of Contracts*, 6 Am. Bus. L.J. 387, 392, 394 (1968). The effect was quickly recognized by efficient breach theorists. *See*, *e.g.*, Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle* (integrating the price effect into their analysis of the penalty rule); Anthony T. Kronman, *Specific Performance*, 45 U. Chi. L. Rev. 351 (1978) (integrating the price effect into the

The more costly to one party the remedy for breach, the higher the price that party will charge up front.

We can now return to the objection that the theory of efficient breach advocates giving the gains of breach to the party in the wrong. But if the remedy is built into the price, expectation damages simply give the nonbreaching party the remedy it paid for. In the above example, expectation damages mean that Buyer pays less for the goods. In exchange for that lower price, Seller is able to keep for itself all of the gains of nonperformance. Complaining about the fairness of this arrangement is like complaining about having to pay the deductible on an insurance policy after receiving the benefit of a lower premium. Any gains that efficient breach gives to the wrongdoer *ex post* have been paid for *ex ante* in the form of more favorable contract terms.[62]

Of course the distributive objection might not be about the fairness of allocating the gains of breach to the breaching party, but about whether the law should "reward" the party in the wrong by allowing it to keep the profits of breach. If this is the objection, the price effect at least identifies an important wrinkle. Sticking with the example, a legal rule that recommends specific performance, disgorgement, or punitive damages for breach will benefit those Buyers who are victims of breach. But that rule will often cost all Buyers at the time of formation. In many market conditions, increasing the cost of breach results in all Buyers paying a higher price for their contracts. Buyers in transactions in which there is no breach pay a price that subsidizes the recovery of Buyers in transactions in which there is a breach. Theorists who advocate these remedies should also be prepared to justify these price effects and the resulting cross-subsidy.

The price effect illustrates a distinctive feature of contract law. Unlike the duties imposed by, say, tort or criminal law, contractual obligations are created by the same individuals who are subject to them. As a result, the legal rules that govern contractual obligations affect not only decisions about their performance or breach, but also decisions, at the time of formation, about what those obligations will be.[63] Economic analysis, with its relentless attention to incentives, has given that fact more attention than have other theories. But an adequate theory of remedial rules, no matter what its principled commitments, cannot ignore the effect of remedies on contract terms. A theory of contract remedies should attend not only to how remedies impact parties' post-formation relationships, how they affect the parties' performance decisions, and the remedies' moral or other post-breach functions. It should also attend to the effects of remedial rules on the formation of contracts.

The price effect provides the starting point for a second and more fundamental modification to the simple theory. Early proponents of the efficient breach theory

analysis of specific performance). For a detailed analysis of price effects, *see* Mahoney, *Contract Remedies and Options Pricing*. For recent treatments, *see* Richard Craswell, *Promises and Prices*, 45 Suffolk U. L. Rev. 735 (2012); Markovits & Schwartz, *The Expectation Remedy and the Promissory Basis of Contract*, at 1961–77.

[62] I believe Richard Craswell was the first to make this point in response to the moral objection. *See* Craswell, *Contract Remedies*, at 642.

[63] As Goetz and Scott put the point, "a decision to enforce promises, and the subsequent choice of remedy, does not merely mold the performance behavior of contracting parties; it also shapes both the nature and amount of promise-making activity." Goetz & Scott, *Enforcing Promises*, at 1266.

based their case on principles of social welfare. Efficient breach, it was argued, is desirable because it results in an allocation of resources that increases aggregate individual welfare. The simple theory occupied the same space in this respect as Guido Calabresi's argument for strict liability in tort[64] or Gary Becker's deterrence-based account of criminal law.[65] Once the price effect is added, the theory no longer needs a social welfare principle. The price effect means that parties themselves want efficient remedies. All that is needed to get the theory off the ground is assigning some weight to the remedies that parties themselves prefer or would choose.

The idea can be illustrated by adding differential transaction costs to the above story. Suppose again that at the time of contracting Seller and Buyer can choose expectation damages or specific performance, but that when performance becomes inefficient, the remedies produce different transaction costs. For simplicity's sake, let us say that under the expectation remedy Seller will breach and voluntarily pay damages whenever nonperformance is more efficient at no additional cost to the parties, and that with specific performance, it will cost each party $20 to negotiate a release that divides the gains evenly. If there is $200 to be gained from nonperformance, with the expectation remedy Seller will breach and keep the entire $200. With specific performance, the parties will negotiate a release and each end up only $80 ahead. Other things being equal, Buyer again prefers an $80 gain from nonperformance to Seller receiving all the gains of breach. But the price effect means that other things are not equal. Suppose again that at the time of contracting both parties expect an average $200 potential gain from nonperformance 10 percent of the time. With the specific performance remedy Buyer and Seller each stands to garner only a risk-adjusted $8 from nonperformance ($80 average gain $\times$ 0.1 probability). That is $12 less than Seller's risk-adjusted $20 gain from expectation damages ($200 average gain $\times$ 0.1 probability). Seller will therefore happily reduce the price by up to $12 in exchange for the expectation remedy. Buyer comes ahead with any price reduction of more than $8, creating a price range in which expectation damages are both Buyer's and Seller's preferred remedy.

The phenomenon is a general one. By definition, efficient remedies increase the total gains of contracting across all possible futures. If in some futures one side ends up with those gains, the other side can benefit at the outset in the form of price or other concessions. As Alan Schwartz has put the point, "[a] promisee who cannot affect the size of his share will want to maximize the size of the pie."[66] So long as efficient

[64] Guido Calabresi & Jon T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 Yale L.J. 1055 (1972).

[65] Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968).

[66] Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 Yale L.J. 369, 377 (1990); *see also* Cooter & Eisenberg, *Damages for Breach of Contract*, at 1360 ("The *price* term of a contract controls the distribution of the value that the contract creates. Revision of an inefficient nonprice term can produce an increase in value, and this increase can be distributed between the parties by adjusting the price term so that each party is better off."); Craswell, *Contract Remedies*, at 633 ("[The] attempt to mimic the result of a perfect bargaining process is equivalent to identifying the remedy that is most 'efficient' in the sense of maximizing the sum of the parties' expected welfare."); Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle*, at 578 ("*In the absence of evidence of unfairness or other bargaining abnormalities, efficiency would be maximized by the enforcement of the agreed allocation of risks embodied in a liquidated damages clause*." (emphasis in original)); Shavell, *On the Design*, at 131 ("[O]ne remedy is Pareto superior to a second if given any contract price and use of the second remedy, both parties would prefer to make some

remedies increase the size of the pie without affecting the proportion that each party gets, both parties prefer efficient remedies.

The path to this result requires some heroic assumptions. I have simply stipulated higher transactions costs under specific performance than under expectation damages. As I observed above, the transaction costs that attach to various remedies depend on empirical facts about which there is considerable disagreement among theorists and on which we have limited data. More generally, the model assumes that the parties are risk neutral, fully informed, and perfectly rational, features that do not describe many actual transactions.

But the point of the revised theory is not to argue that legislators or courts should adopt one or another remedial rule. It is to illustrate the relevance of efficiency to almost any theory of contract remedies. That relevance follows from what I take to be three relatively uncontroversial premises. First, one function of contract law is to enable parties to better achieve their individual ends. Second, many parties enter into contracts to maximize their individual gain from a transaction. Third, remedies often affect prices. The three premises together make a prima facie case for efficient remedies. Where the price effect exists, efficient remedies enable both parties to increase their individual gain from the transaction. The argument for efficient remedies does not require a principle of social welfare, but only some deference to what, at the time of formation, the parties want from their transaction.[67]

None of this is to say that efficiency should be the sole, or even principal, guide in the choice of remedies. If enabling parties to achieve their individual ends is one purpose of contract law, it need not be the only purpose or sole governing principle. And some parties might happily pay a higher price for inefficient remedies that they prefer for other reasons. But we need an argument that one or the other is the case. Many theories of contract argue for the theorist's preferred remedy with limited attention to its efficiency. Such theories are incomplete unless they also demonstrate either that the theorist's reasons for imposing her preferred remedy are

adjustment in the price and to employ instead the first remedy."); Shavell, *Specific Performance Versus Damages for Breach of Contract*, at 841 ("[I]f the contractual 'pie' the parties have to divide would be increased by a change in the remedy for breach, there has to be a way to slice the pie (by means of a price adjustment) so that each has more pie to enjoy and thus is happier.").

[67] The point can be found in the efficient breach literature as early as 1972. Barton, *The Economic Basis of Damages for Breach of Contract*, at 285–6. Writing on another topic in 1977, Richard Posner and Andrew Rosenfeld make it as follows:

> If the purpose of the law of contracts is to effectuate the desires of the contracting parties, then the proper criterion for evaluating the rules of contract law is surely that of economic efficiency. Since the object of most voluntary exchanges is to increase value or efficiency, contracting parties may be assumed to desire a set of contract terms that will maximize the value of the exchange. It is true that each party is interested only in the value of the contract to it. However, the more efficiently the exchange is structured, the larger is the potential profit of the contract for the parties to divide between them.

Richard A. Posner & Andrew M. Rosenfeld, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Legal Stud. 83, 89 (1977); *see also* Shavell, *Damage Measures*, at 489 ("The utility of damage measures to contracting parties themselves is no doubt a and perhaps *the* major aspect in which the social advantage of damage measures adhere. Furthermore, it affords a more appealing explanation of the observed use of damage measures than an explanation based on the notion that they are in the diffuse social interest.").

sufficiently important to sometimes defeat party preferences, or that parties themselves are likely to prefer the recommended remedy notwithstanding its potential inefficiencies.

The third modification to the simple theory builds on the second. The simple theory, like Fuller and Perdue's puzzle, treats the remedy question in contract as similar in kind to the question in tort or criminal law. It identifies a legal wrong and asks what legal consequence lawmakers should attach to it. But in contract law there is a prior question. The duties of tort and criminal law are established by legislatures and judges. Contractual obligations are established by parties who are then subject to them. Because contract law delegates to parties the power to create the duty, it might also delegate to them the power to choose, at the time of formation, the remedy for its breach. In contract law, the first question is not what the remedy should be, but who should have the power to choose it. Should the remedial rule be a mandatory one, picked by officials and binding on the parties, or a default plus altering rule, designed to allow the parties to decide? The simple theory elides that question. Like Fuller and Perdue, it simply assumes that the remedial choice will be made by legal officials, not by the parties.

In the model, the who-decides question transforms economic criticisms of the simple theory—it simplifies too much—into reasons for delegating to parties the choice of remedy. The argument is one of relative competence. In the model, parties at the time of formation are likely to know more than legislators or courts about which breaches are obviously inefficient, and so should be punished rather than priced, about which remedies will allow the parties to avoid inefficient performance most cheaply, about how one or another remedy will influence the many decisions the parties will take in the transaction and the relative importance of each, and about how to balance such incentive effects against risk allocation and other functions the remedy might serve in their transaction. For reasons canvassed under the previous point, parties themselves prefer more efficient remedies. In the model, therefore, both principles of social welfare and a commitment to helping parties achieve their ends recommend allowing the parties to choose the remedy.[68] Hence the observed convergence between efficiency and autonomy theories of contract.[69]

This final revision to the simple theory transforms it from a theory of efficient breach to a theory of efficient remedies more generally. In some transactions the parties might choose expectation damages because the expectation measure gives a party the option to perform or pay damages. In other transactions, or for certain types of breaches, the parties might pick other remedies. The most the revised theory can now offer is an argument for setting the default at expectation damages. Such an argument might, for example, be that most parties prefer expectation damages. In that case, it

[68] For a classic deployment of this argument, *see* Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies*.

[69] *See*, *e.g.*, Charles Fried, *The Ambitions of* Contract as Promise, *in* Philosophical Foundations of Contract Law 17, 21–4 (Gregory Klass, George Letsas, & Prince Saprai eds., 2014). The convergence is the result of assumptions baked into the neoclassical model such as individual rationality and knowledge and the exogeneity of preferences. Those assumptions are consistent with the priors of many autonomy theories, and are also contestable.

will involve empirical claims about relative transaction costs, the relative importance of various incentive effects and remedial functions, and the like.[70]

The above case for party choice relies on assumptions baked into the model. First, it assumes parties who have perfect knowledge and are perfectly rational. In the actual world, often neither is the case. Where parties are ill-informed or imperfectly rational, legislatures or courts might do a better job at picking the remedy that maximizes value or best realizes the parties' own goals. Again, this is an empirical question.

Second, the argument makes strong assumptions about society's reason for providing a remedy for breach. Deciding who should choose involves an inquiry into the relative competence and proper incentives of different institutional actors, which in turn depends on the design goal. If contract law's only purpose is to maximize social welfare, expand individual autonomy, or some combination of the two, the choice of remedies should be given to knowledgeable rational parties at the time of contracting.[71] If, on the contrary, we enforce contracts in order to protect the nonbreaching party's reliance, restitution, or expectation interests, that is an argument for mandatory limits on parties' ability to choose remedies that do not serve that end, such as penalties for breach.[72] If we believe contracts create a natural property right in performance, that is a reason for mandating disgorgement for some breaches, no matter what the parties' preferences.[73]

Although the revised theory does not integrate these alternative accounts of the functions of and justifications for contract law, it contains lessons for them. The first is simply to attend to the question of who chooses. Too often contract theorists reason directly from an account of contractual rights to conclusions about the proper remedy for breach. To the extent such theories advocate giving the choice of remedy to judges or legislators, they neglect an essential step. We need an argument why, when we allow the parties to make so many choices about their transaction, we should take this one away from them. Without such an argument, the remedial question is about only defaults and altering rules: What remedy when parties have not expressed an intent one way or another, and what expressions of a contrary intent suffice to defeat the default? If that is the only question, principled debates about contract remedies become much less interesting.[74]

The second lesson concerns design options. I have been speaking as if the who-chooses question has only two possible answers: parties or legal officials. Attention to economic analyses of contract design reveals a number of intermediary possibilities.

[70] *See*, *e.g.*, Markovits & Schwartz, *The Expectation Remedy and the Promissory Basis of Contract*. Alternatively, the argument for one or another default might involve nonmajoritarian considerations, such as the desirability of creating new incentives to reveal information through the process of contracting around the default. Proposals for bargain-forcing default remedies are rare, but *see* Scott & Triantis, *Embedded Options*, at 1476–90 (recommending "a bargain-forcing default that not only maximizes the freedom to contract for termination rights but indeed also encourages the parties to bargain explicitly over these provisions").

[71] *See*, *e.g.*, Jody S. Kraus, *The Correspondence of Contract and Promise*, 109 Colum. L. Rev. 1603 (2009).

[72] Ian R. Macneil, *Power of Contract and Agreed Remedies*, 47 Cornell L. Rev. 495, 496–8 (1962); *see also* Birmingham, *Notes on the Reliance Interest*, at 220 (suggesting that contract serves both compensation and efficiency goals).

[73] *See*, *e.g.*, Friedmann, *Restitution of Benefits*.

[74] The first to emphasize the implications for contract theory was Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 Mich. L. Rev. 489 (1989).

First, and most obviously, mandatory limits on the power to pick the remedy can leave room for party choice. The penalty rule, while prohibiting certain remedial choices, leaves many options to choose from. More subtly and importantly, lawmakers can tailor defaults to particular types of transactions or parties, they can pick defaults that are more or less sticky, and they craft altering rules that make it more or less costly to contract around the default.[75] These design options provide mechanisms for giving different weight in different circumstances to the various competing principles and purposes of contract law. Suppose, for example, a theorist holds that the point of contract law is to achieve some measure of corrective justice, and that corrective justice requires that the breaching party provide the monetary equivalent of performance. This suggests setting the default at expectation damages. Depending on the importance of that goal, on the value the theorist also attaches to party autonomy, efficiency, or other purposes, on her assessment of the effects of a mandatory rule on the formation of contracts, and so forth, the theorist might want to make it more or less difficult to contract around that default. More generally, as I have written elsewhere:

> Stickier defaults, and by implication costlier opt-outs,… can mediate between the sometimes conflicting interests the law has in, on the one hand, granting parties the power to control the scope of their legal obligations and, on the other hand, imposing liability on parties because of extralegal wrongs they have committed, harms they have caused, or other considerations.[76]

Economic analyses of the design question provide new tools for understanding what is possible in contract, and especially how remedial rules can respond to the multiple functions contract law might serve. Only by attending to the design literature can contract theorists know what principles and purposes contract law is able to advance.

There is more to say on the complex distributive effects of remedies, the prediction that many parties would choose efficient remedies, and the various ways to design remedial rules to incorporate party choice. I hope I have said enough, however, to convince that contract theorists, no matter what their other commitments, should pay attention to the revised theory of efficient breach. Whether or not the model describes the world, it reveals aspects of contract remedies that we might not otherwise see and provides a deeper understanding of the principles and purposes contract law might serve.

Conclusion

Many common criticisms of the efficient breach theory attack a theory no one holds. Sophisticated economic accounts of contract remedies have moved far beyond the simple theory of efficient breach. But a revised theory holds important lessons for contract theory. The revised theory illustrates special difficulties in evaluating the distributive consequences of contract remedies, given that the remedy is likely to affect the price or other contract terms. It predicts that many parties will want efficient remedies,

[75] *See* Ian Ayres, *Regulating Opt-out: An Economic Theory of Altering Rules*, 121 Yale L.J. 2032 (2012).
[76] Gregory Klass, *Intent to Contract*, 95 Va. L. Rev. 1437, 1472 (2009).

putting the burden on theorists who do not consider efficiency to explain why their preferred remedy should sometimes trump party preferences. And it calls attention to the option of delegating the remedial decision to the parties themselves and suggests new tools for doing so.

More broadly, the revised theory of efficient breach illustrates the interplay between, on the one hand, the functions and justifications of contract law and, on the other, its design. Contract theorists should attend not only to the general distinguishing feature of contract law—that it provides for the private enforcement of voluntary obligations—but also to the special set of design challenges and options that result. The rules of contract law affect parties' behavior in distinctive ways. And contract law's delegation to parties of a limited law-making power provides design options not available elsewhere. Only by attending to the details of contract design can contract theorists understand what functions contract law can serve and what principles might justify it.