

1-1-2006

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Recommended Citation

Dawinder S. Sidhu, *The Immorality and Inefficiency of an Efficient Breach*, 8 Transactions: The Tennessee Journal of Business Law 61 (2006).

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SMALL SCHOOL.
BIG VALUE.

THE IMMORALITY AND INEFFICIENCY OF AN EFFICIENT BREACH

DAWINDER S. SIDHU*

INTRODUCTION

The American economy's recent decline is one of the most significant issues facing the American public and its leaders today. This economic slump was caused by several factors, including the terrorist attacks of 2001 and the deflation of the "dot com" bubble. For the purposes of this Article, the most important factor is the offensive behavior of three categories of actors in the American market: 1) major corporations, 2) those purporting to objectively account for the financial activities of these corporations, and 3) analysts who provide the lay investor with ostensibly reliable information about these corporations.

The American and international communities have witnessed a severe collapse in faith in the market due to what Federal Reserve Chairman Alan Greenspan described as an "infectious greed."¹ This attitude of greed and irresponsibility has not only infected major corporations, prestigious brokerage houses, and once disinterested accounting firms, but has also deflated the precious earnings and savings of thousands of employees and investors. Moreover, loyal workers have been deprived of these indispensable earnings and savings while the executives and corrupt analysts have added millions to their own bank accounts.

The acuteness and pervasiveness of this greed—the extent of which is still being uncovered—combined with the apparent lack of legal safeguards to eliminate such gross behavior (or the failure to enforce the safeguards that do exist), has resulted in a crippled market and a significant decline in consumer confidence. More importantly, the American people are now questioning the existence or efficacy of the rule of law in the business world, and are also considering whether morality has had any relevance in either the daily market operations or the rule of law.

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¹ Testimony of Chairman Alan Greenspan, Federal Reserve Board's semiannual monetary policy report to the Congress, July 16, 2002, <http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm> (last visited Oct. 15, 2006).

As criminal prosecutions of certain actors are pending and as other guilty parties still defy detection, the severity of these greedy practices remains unknown. This uncertainty is precisely why American consumers are still wary of the market. This decline in consumer confidence necessitates a meaningful analysis of the relationship between the law, morality, and profit-motivated activities. The result of this analysis may exacerbate or alleviate the public's confidence in the legal system, in moral principles, and in self-interested actors (e.g., a corporate officer or even a single consumer); however, at least some uncertainty may be dispelled.

This Article attempts to analyze a concept in contract law known as the doctrine of efficient breach, which “compels [or at least encourages or invites] a party to a contract to breach if they can compensate the other party and remain better off than if they had fully performed the contract.”² This doctrine appears to encourage immoral conduct, namely the breach of a contract. However, in the name of economic efficiency, wealth maximization, and social wealth, several prominent legal scholars, including Judge Richard A. Posner, the “leader of the school of Law and Economics movement,”³ have argued that an efficient breach is justified. In contrast, the efficient breach theory has been challenged by a number of critics, including Charles Fried.

As contracts form the very basis of business-related activities and, as we shall see, the essence of social interaction itself, the study of contract law helps us understand the present socioeconomic climate and the legal apparatus that is supposed to control socially undesirable behavior. The doctrine of efficient breach exists on the cutting edge of contract law, particularly as the influence of economic analysis continues to grow in the law.⁴ Consequently, a critique of this doctrine provides useful insights into the relation between law, morality, and contracting.

The analysis of the efficient breach doctrine will enrich the current debate on whether an opportunistic breach is moral and should be endorsed by the law. If it is

² Craig S. Warkol, *Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach*, 20 CARDOZO L. REV. 321, 321-22 (1998) [hereinafter Warkol].

³ Scott T. Powers, *Commerce—A Retreat from Clarity: The Supreme Court Adds a Wrinkle to the “Aggregated Effects” Doctrine of its Commerce Clause Jurisprudence—United States v. Morrison*, 519 U.S. 598 (2000), 75 TEMP. L. REV. 163, 194 (2002).

⁴ See David O. Brink, Ian Shapiro and Judith Wagner Decen, eds., *Theory and Practice: NOMOS XXXVII*, 47 J. LEGAL EDUC. 270, 272 (1997) (book review) (“One of the striking changes in the law curriculum in recent years has been the significant increase in theoretical and interdisciplinary study. The influential and growing law and economics movement is just the most salient instance of this trend . . .”).

shown that a contract should be breached to further the wealth of specific actors or society as a whole, then those concerned with the current decline in morally satisfactory conduct among the aforementioned categories of actors should be especially anxious. If, on the other hand, the doctrine of efficient breach is an empty promise, either a victory for morality must be signaled or it must be shown that the economic justification for an efficient breach is faulty. Accordingly, a discussion of this doctrine from moral and economic perspectives will help shed light on the relation between morality and contracting as a whole.

Part I will explain the doctrine of efficient breach, particularly its economic justifications, and will offer examples of circumstances where a breach of contract is argued to be efficient and socially desirable. Part II will discuss the nature of contracting as an institution and its importance in the development of society. Due to this importance, the rule of law must respect the will of the parties and other philosophical virtues, such as liberty, autonomy, and freedom. Part III will present the moral opposition to the doctrine, specifically the objections of Fried and his contemporaries. This Part will also offer a rejoinder to the moral commentators in Judge Posner's finding that morality is merely an expression of value judgments and, consequently, that it is irrelevant in an appraisal of the legal doctrine. In Part IV, Posner's reply and the economic justifications for the efficient breach will be proven inadequate. Moreover, current remedies for breach of contract will be found insufficient to deter an efficient breach or fully compensate those affected. As a result, it will be concluded that legal scholars should refrain from encouraging this doctrine. They should perhaps content themselves with the intellectual intrigue that the doctrine has generated,⁵ and discuss the theory purely as an academic exercise in the confines of law schools, rather than promote its use in real life.

⁵ Law professors and students are widely exposed to the doctrine of efficient breach. See Thomas S. Ulen, *Law's Order: What Economics Has to Do with Law and Why It Matters*, 41 SANTA CLARA L. REV. 643, 645 (2001) (book review); Warkol, *supra* note 2, at 321 ("The theory of efficient breach is a powerful academic tool.").

PART I. THE DOCTRINE OF EFFICIENT BREACH

*The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, —and nothing else. . . . If you commit a [breach of] contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference.*⁶

- Oliver Wendell Holmes

A. Definition and Examples

This famous quote by eminent judge and pragmatist⁷ Oliver Wendell Holmes is the basis for the doctrine of efficient breach. Objective examination of the law has been stated to be “a jurisprudence that, like legal realism, draws on the philosophy of pragmatism.”⁸ In his seminal paper, *The Path of the Law*, Holmes determined that the law is a prediction of what judges will do.⁹ The law is indeterminate since a judge is not entirely bound by past decisions, precedent may not be on point, and the judge may use any number of different considerations in reaching a decision (e.g., “anecdote, introspection, imagination, common sense, empathy, . . . metaphor, analogy, precedent, custom, memory, ‘experience,’ intuition, and induction”¹⁰). No one can accurately predict how a judge may decide a case or what reasoning he will use to justify his legal conclusions. As a result, if a client comes into an attorney’s office and asks what “the law is” in his particular circumstance, the best the attorney can do is offer a prediction of what the judge may do. This prediction may be based on existing precedents, the attorney’s understanding of the judge’s own personal experiences or views, and any other relevant consideration that the attorney feels may impact the judge’s reasoning.

In cases involving a breach of contract, Holmes recognized that the law requires the breaching party to pay only compensatory damages.¹¹ This is primarily

⁶ Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) [hereinafter Holmes].

⁷ See RICHARD A. POSNER, *THE PROBLEMS OF JURISPRUDENCE* 19 (Harvard Univ. Press 1990) [hereinafter JURISPRUDENCE].

⁸ *Id.* at xii.

⁹ Holmes, *supra* note 6, at 461.

¹⁰ JURISPRUDENCE, *supra* note 7, at 73.

¹¹ See Geoffrey R. Watson, *In the Tribunal of Conscience: Mills v. Wyman Reconsidered*, 71 TUL. L. REV. 1749, 1750 (1997) [hereinafter Watson].

due to the fact that remedies in contract law are historically intended to compensate and not to punish.¹² “Contract law, [Holmes] argued, simply compensates for breach; it does not punish for moral failure.”¹³ Thus, the reason a party breaches a contract does not matter. As Posner states, “the law [of contracts] doesn’t really care about intentions.”¹⁴ The remedy is the same even if the breach is considered “immoral,” and notwithstanding the intent of the breaching party. Summarizing Holmes’ understanding of a breach, and the law in general, Posner writes that “the legal duty to keep a promise is merely a prediction that if you don’t keep it you’ll have to pay for any harm that breaking your promise imposes on the promisee.”¹⁵

If a party enters into a contract and subsequently learns of another possible contract that would give him a greater profit, he may be tempted to breach the first in order to enter into the second. He may not mind paying damages to the non-breaching party¹⁶ so that he may enter into the second, more profitable contract. For example, A enters into a contract with B wherein A is to deliver 5,000 widgets in three months for \$50,000. However, a month later, A learns that C is willing to pay \$110,000 for delivery of the same 5,000 widgets. A will breach the contract since he will obtain at least \$10,000 more in profit after compensating B for either B’s reliance damages or damages based on A’s expected gains. To summarize,

The traditional goal of the law of contract remedies has not been compulsion of the promisor to perform his promise but compensation of the promisee for the loss resulting from breach. “Willful” breaches have not been distinguished from other breaches, punitive damages have not been awarded for breach of contract, and specific performance has not been granted where compensation in damages is an adequate substitute for the injured party. In general, therefore, a party may find it advantageous to refuse to perform a

¹² Stephen B. Katz, *The California Tort of Bad Faith Breach, the Dissent in Seaman’s v. Standard Oil, and the Role of Punitive Damages in Contract Doctrine*, 60 S. CAL. L. REV. 509, 521 (1987) (“One of the oldest saws in contract law is the assertion that damages are designed to compensate, and not to punish.”).

¹³ Watson, *supra* note 11, at 1750.

¹⁴ RICHARD A. POSNER, *THE PROBLEMATICS OF MORAL AND LEGAL THEORY* 208 (Belknap Press 1999) [hereinafter *PROBLEMATICS*].

¹⁵ *Id.* at 207.

¹⁶ These damages may include, for example, the reasonable reliance costs endured by the other party or the expected benefit that the other party reasonably anticipated he would receive.

contract if he will still have a net gain after he has fully compensated the injured party for the resulting loss.¹⁷

B. Economic Justifications

Posner and other adherents to the law and economics school argue that a breach in such circumstances as our example is “efficient.” Efficiency is measured in several ways. First, an economic action is said to be efficient if it is Pareto superior, meaning that someone is made better off without making any person worse off.¹⁸ In our example, a breach would be efficient since A would be better off by at least \$10,000 and B is said not to be worse off since he receives compensation.

Under a second measurement of efficiency, the Kaldor-Hicks standard, an economic action is said to be efficient if the new outcome makes those who benefit sufficiently better off so that they would still receive an increase in utility even if they compensated the losers.¹⁹ In other words, “a benefit to one individual, even if it carries with it a loss to another, increases society’s welfare so long as the benefited party is able fully to compensate the losing party and to remain better off than before.”²⁰ In our example, A’s breach of his contract with B is efficient under the Kaldor-Hicks standard since he is *able* (even if he is *not required*) to compensate B and still be better off by at least \$10,000 after contracting with C. The Kaldor-Hicks measure of efficiency is essentially the same as Posner’s measure of wealth maximization.²¹ Wealth maximization, which is a more callous representation of the Kaldor-Hicks standard, “requires only that the winners’ gains exceed the losers’ losses.”²²

¹⁷ Peter Linzer, *On the Amorality of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111, 111 (1981) (citing RESTATEMENT (SECOND) OF CONTRACTS ch. 16, intro. note (1981)) [hereinafter Linzer].

¹⁸ JULES COLEMAN, *MARKETS, MORALS, AND THE LAW* 97 (1988).

¹⁹ *Id.* at 98.

²⁰ Linzer, *supra* note 17, at 114.

²¹ See Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 491 (1980).

²² JURISPRUDENCE, *supra* note 7, at 389.

Thomas Schelling offers another helpful, albeit rudimentary, means of analyzing whether an action increases efficiency. Schelling states that economists must “explore whether, in respect of alternative outcomes or consequences, some alternative policy or condition or program technique is ‘better.’”²³ Thus, A’s move was efficient since the contract with C is more profitable than the original contract with B. Conversely, it would have been inefficient for A to honor his contract with B since there is “something better” that he is aware of, namely the contract with C.

Economists, including Coase²⁴ and Posner,²⁵ also evaluate efficiency by examining whether the good, service, or entitlement resides with the party that values it more. Professor E. Allan Farnsworth explains, “Economic analysis posits that if there is a second buyer who values the widget more highly than you or I do, it is efficient for that buyer to acquire the widget.”²⁶ In the example above, the 5,000 widgets will be provided to C, who is willing to pay \$110,000 for their delivery—a price that is greater than B’s price. That C values the delivery of the widgets more than B is reflected in this greater contract price. Since A is always self-interested, he will be on the lookout for better deals, and, of course, will be receptive to ones that will provide him with a larger return. Posner, and similarly minded commentators, advocate efficient breaches because social wealth is increased with efficient transactions. Society is at least \$10,000 better off if A contracts with C after A breaches with B. Posner proclaims, “[t]he ultimate test of a rule derived from economic theory is not the elegance or logicity of the derivation but the rule’s effect on social wealth.”²⁷ Viewed in this light, an efficient breach is socially desirable and socially advantageous since it enlarges social wealth.

The merit of these economic justifications will be assessed in Part IV.

²³ Thomas C. Schelling, *Economic Reasoning and the Ethics of Policy*, 63 THE PUB. INT. 37, 50 (1981).

²⁴ See Robert Cooter, *Cost of Coase*, 11 J. LEGAL STUD. 1, 18 (1982).

²⁵ See *Patton v. Mid-Continent Sys., Inc.*, 841 F.2d 742, 750-51 (7th Cir. 1988) (“The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee’s actual losses.”); *Walgreen Co. v. Sara Creek Prop. Co.*, 966 F.2d 273, 274 (7th Cir. 1992) (“Many breaches . . . are ‘efficient’ in the sense that they allow resources to be moved into a more valuable use.” (citing *Patton*, 841 F.2d at 750-51)); Barbara White, *Coase and the Courts: Economics for the Common Man*, 72 IOWA L. REV. 577, 589 (1987).

²⁶ E. Allan Farnsworth, *Your Loss of My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1380 (1985) [hereinafter Farnsworth].

²⁷ JURISPRUDENCE, *supra* note 7, at 362.

PART II. THE ESSENCE OF CONTRACTING

*Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of.*²⁸

- Adam Smith

A. The Birth of Society

Imagine, if you will, a natural state of man, a hypothetical and abstract situation in which individuals are in a pre-social state with no organized society—no laws, no rules, and no authoritative agency; they are in the “original position.”²⁹

Individuals in this primitive state survived by consuming goods that they themselves produced. One can envision the hunter, perhaps even a pack of hunters, killing an animal that he or they would feast on later that evening. Or one can imagine a family of farmers that produces certain plants and animals for sustenance. While such a process can be entirely internal (e.g., within the family unit or a clan based on family relationships), there comes a point where the self-satisfying dynamic is no longer sufficient to provide the members of the group with their requisite needs or wants.

For example, an injured husband and pregnant wife are unable to mend their house that was recently devastated by an act of God; therefore, they require the services of another individual, a physician, who does not depend on this family for his sustenance or livelihood. The husband needs medical attention so he will be able to repair the roof of the house and provide a living for the mother and the arriving child.

As another example, a unit may have had an extremely productive hunt or bountiful harvest and thus is in possession of an excess of food. Rather than let this surplus go to waste, as a unit can only consume a limited amount since the fruits of its labor will become inedible with time, the unit will want to barter this surplus for other goods or services. The surplus can be of some value and provide some utility to someone else, even though the unit itself cannot consume the surplus.

²⁸ ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 21 (9th ed. 1799) (1776) [hereinafter SMITH].

²⁹ See JOHN RAWLS, A THEORY OF JUSTICE 15-17 (1971).

As a final example, suppose there is an extraordinarily successful unit with a sizable surplus, or a unit that is simply tired of consuming the same goods. A unit in either of these positions will desire to barter some of its goods in exchange for others in order to obtain a diverse set of consumable goods—perhaps a loaf of bread where the unit habitually consumes chicken. A successful unit with a surplus of goods may simply desire to possess a luxury good that is worthy simply because it is possessed—for instance, a sculpture.

In each of these instances, it is clear that the families or small units will desire to exchange part of their goods—whether out of the main share or out of a surplus—in order to obtain other goods or services that they are unable to produce internally. As Adam Smith noted, “[man] supplies the far greater part of [goods or labor that is produced in surplus] by exchanging that surplus . . . which is over and above his own consumption, for such parts of the produce of other men’s labour as he has occasion for.”³⁰ The farmer who still brings in corn by the bushel can now have imported tea to go along with his meal; the injured man can not only obtain medical services, but can also find someone to repair his house and perhaps also someone to help deliver the baby.

Accordingly, social interaction is necessary for the families and group units to achieve better, more enjoyable lives. More eloquently, as Fried states, “a regime of mutual respect allows men and women to accomplish what in a jungle of unrestrained self-interest could not be accomplished.”³¹ Through such interaction, individuals not only benefit more than they would in an isolated situation, but they also reduce the risk that each would have otherwise faced on their own.³²

Since people in a state of nature are similarly situated—that is, generally subject to the same basic needs and same risks that nature may unfortunately confer—it is inevitable that all individuals will be interested in exchanging. Accordingly, there are many people who could benefit from social interaction,

³⁰ Smith, *supra* note 28, at 33.

³¹ CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION 17 (1981) [hereinafter PROMISE].

³² Political philosopher Thomas Hobbes believed that the primary benefit of society was to control violence and aggression and thereby reduce risk and uncertainty. PIERRE ROSANVALLON, THE NEW SOCIAL QUESTION: RETHINKING THE WELFARE STATE 11-12 (Barbara Harshav trans., Princeton Univ. Press 2000) (1995). Indeed, a French revolutionary, Clavière, wrote that the sharing of this mutual risk combined with the insurance that a community creates brings individuals together. *Id.* at 12.

including everyone in the region that can be reached by available methods of transportation and communication. As Adam Smith states:

When the division of labour has been once thoroughly established, it is but a very small part of a man's wants which the produce of his own labour can supply. He supplies the far greater part of them by exchanging that surplus part of the produce of his own labour, which is over and above his own consumption, for such parts of the produce of other men's labour as he has occasion for. Every man thus lives by exchanging, or becomes in some measure a merchant, and the society itself grows to be what is properly a commercial society.³³

Moreover, as the dynamic of exchange continues, the ability to produce will necessarily increase due to the fact that men will innovate (i.e., improve their goods and services) because they know they are able to exchange with others. Smith observed,

[T]he certainty of being able to exchange all that surplus part of the produce of his own labour, which is over and above his own consumption, for such parts of the produce of other men's labour as he may have occasion for, encourages every man to apply himself to a particular occupation, and to cultivate and bring to perfection whatever talent or genius he may possess for that particular species of business.³⁴

Society thus develops because of, and is dependent on, the social interaction that takes place due to the freedom to exchange and the knowledge that others will invariably exchange out of want or need. With the pool of consumers likely to equal the number of individuals in the society, and with the increased productivity of these consumers, the frequency of interaction will increase rapidly. A market, or, more correctly, a "commercial society," emerges.

B. Formal Contracting in Society

As society develops, the number of participants in the market and the number of transactions increase. Accordingly, as society grows, the probability of

³³ SMITH, *supra* note 28, at 33.

³⁴ *Id.* at 23.

fraudulent transactions increases and problems with the exchange process surface. For instance, a consumer may be upset that the table he obtained for a month's supply of ripe tomatoes was not made of oak, but of a wood of inferior quality, despite the table-maker's assurances that the table would be made of oak. Or a consumer may not believe it is fair that he must surrender milk from his cows or face a beating by a coalition of brutes who either have no resources of their own to barter, or simply wish to hoard what they have and use their strength to obtain goods for nothing in return.

It is clear that men in a state of nature do not have to refrain from abhorrent or unfair conduct. Since there is no authority to prevent such conduct, aside from another, more powerful person who imposes his own will, an individual can act as he pleases. There is, of course, no assurance that these actions will be in accord with what a majority of the members of a community deem honest, fair, or right. This leads to John Stuart Mill's famous declaration: "The only freedom which deserves the name, is that of pursuing our own good in our own way, so long as we do not attempt to deprive others of theirs, or impede their efforts to obtain it."³⁵ Such a statement is only useful if it can be enforced. Enforcement can only occur either through those who appeal to their own consciences, or through a supervising entity. The fact that people sometimes act in a socially undesirable manner implies that not all individuals limit their own conduct. The sanctions imposed by one's conscience (e.g., shame or guilt) are often insufficient to deter conduct that harms others. This leads to an obvious conclusion: societies require governments to enforce social norms of proper behavior. More specifically, market activities must be subject to some sort of supervision.

In order for this governmental entity to emerge, the individuals who wish to avail themselves of the benefits of the superior agency must not only consent to the authority of this body, but must also surrender some of the rights they could have exercised in an original position or state of nature. John Locke wrote, "there only is political society where every one of the members has given up his natural power, surrendered it into the hands of the community And thus . . . the community comes to be the umpire by settled standing rules, impartial and the same to all parties"³⁶

³⁵ JOHN STUART MILL, ON LIBERTY, *reprinted in* PHILOSOPHY OF LAW 198, 199 (Joel Feinberg & Hyman Gross eds., 1995). Mill qualified or explained this principle by differentiating between "harm" and "offense;" the former exists as an infringement of others' rights while the latter does not. *Id.* at 201-02.

³⁶ JOHN LOCKE, OF CIVIL GOVERNMENT, *in* 3 CLASSICS OF WESTERN THOUGHT, THE MODERN WORLD 68, 72 (Edgar E. Knoebel ed., 4th ed., 1988).

Superior agency must exist in order to establish a general set of “standing rules” to govern all socially undesirable conduct, and, more specifically, to fix a set of standards by which transactions occur. Moreover, the superior agency must determine whether a violation of these rules has occurred, and levy sanctions accordingly. What should such standards, or laws, contain? It is helpful to think of the law as an actual person, an “umpire” in the words of Locke,³⁷ who supervises the bargaining process between a seller and buyer.

The first problem for society is how to regulate these transactions to ensure they are voluntarily made. Economist Milton Friedman correctly stated that “[t]he basic problem of social organization is how to co-ordinate the economic activities of large numbers of people.”³⁸ He further acknowledged that an essential role of law and order is “to prevent physical coercion of one individual by another.”³⁹ The law, as our hypothetical person or “umpire,” would ensure that a buyer would not be beaten up for his goods or threatened to exchange for a cheaper price. The concepts of duress and undue influence in contract law ensure that threats or compulsion are not used to secure a transaction.⁴⁰

Once it is determined that the two parties are bargaining voluntarily and freely, the law requires that there be an offer, an acceptance of the offer, and consideration between the two parties. An offer and acceptance are merely procedural requirements; consideration is the exchange of a promise for either a promise or performance. However, the law will not assess the relative values of what is being exchanged; it will merely ensure that something valuable is in fact exchanged. As Fried opines, “[G]oodness of the exchange is for the parties alone to judge—the law is concerned only that there *be* an exchange.”⁴¹ Moreover, “a system in which judges may—in the absence of fraud, duress, or some other demonstrable defect in the formation process—second-guess the wisdom of the parties may create

³⁷ *See id.*

³⁸ MILTON FRIEDMAN, CAPITALISM AND FREEDOM 12 (1962).

³⁹ *Id.* at 14.

⁴⁰ *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 174-76 (1981). Even if an individual is not being coerced by another individual, he may still be acting involuntarily (e.g., if he is mentally incompetent). The defense of incapacity in contract law ensures that contracts are voluntarily entered into, notwithstanding the conduct of the other market participant. *See* RESTATEMENT (SECOND) OF CONTRACTS § 12 (1981).

⁴¹ PROMISE, *supra* note 31, at 29.

more substantive unfairness than it cures,”⁴² as the judge’s intervention may disrupt the reasonable expectations that both parties had in benefiting from the particular exchange and in the contracting process generally. However, the law does not accept “sham consideration,” for example, “[w]here a father exchanges \$5000 for a peppercorn from his son, such a promise is not enforceable.”⁴³ If an offer and acceptance are communicated effectively and timely, and if something valuable is exchanged, the law will disturb the exchange only in very exceptional circumstances, including duress, unconscionability, mutual mistake, and frustration of purpose.⁴⁴

Another necessary step in the evolution of a sophisticated market is the establishment of a monetary system, such that one can exchange goods for money and then use money to buy goods and services from others. It is with money that the value of goods and services is quantified, and the process of exchange becomes easier. As Friedrich Hayek explained, “[P]rices can act to co-ordinate the separate actions of different people in the same way as subjective values help the individual to coordinate the parts of his plan.”⁴⁵ Adam Smith also stated:

To prevent such abuses, to facilitate exchanges, and thereby to encourage all sorts of industry and commerce, it has been found necessary . . . to affix a public stamp upon certain quantities of such particular metals It is in this manner that money has become . . . the universal instrument of commerce, by the intervention of which goods of all kinds are bought and sold, or exchanged for one another.⁴⁶

⁴² Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 286 (1986).

⁴³ Craig Leonard Jackson, *Traditional Contract Theory: Old and New Attacks and Old and New Defenses*, 33 NEW ENG. L. REV. 365, 401 (1999).

⁴⁴ See Robert H. Jerry, II, *Insurance, Contract, and the Doctrine of Reasonable Expectations*, 5 CONN. INS. L.J. 21, 34 (1998) (noting that this “policing function” is served by “the doctrines of duress, fraud, concealment, misrepresentation, unconscionability, mistake, impracticability, and supervening frustration.”); Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-ups*, 21 CARDOZO L. REV. 1, 8 (1999) (“Courts are reluctant to police agreements so as not to undermine ‘the policy favoring the stability of transactions and the protection of the parties’ expectations.”) (quoting E. ALLAN FARNSWORTH, CONTRACTS § 4.1 (2d ed. 1990)).

⁴⁵ Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 526 (1945), available at <http://www.virtualschool.edu/mon/Economics/HayekUseOfKnowledge.html>.

⁴⁶ SMITH, *supra* note 28, at 37, 41.

The superior agency can act to regulate the initial distribution and continuous issuance of money, and to ensure that transactions themselves are conducted properly.

In the simple scenario that we have examined so far, one member of society exchanges goods (e.g., vegetables, or the monetary equivalent thereof) for other goods (e.g., wine, or the monetary equivalent thereof). The marketplace, and the broader society that arises around it, is primarily based on these immediate transactions. The law overseeing the exchange between two individuals would surely ensure that one party would not beat up the other for a better price, or that one party would not defraud the other. Less obvious, and certainly not beyond question, is whether the law would permit a seller to make a contract, break it, compensate the buyer, run to the other side of the market, and engage in a contract with another buyer who offers a better price. This sequence of events is said to benefit the person who has breached his first contract and entered into the second, and thus, indirectly, to enhance the welfare of every single person in the society.

PART III. THE MORAL OBJECTION

Leges sine Moribus vanae
(*Laws without morals are in vain*)⁴⁷

- Motto of the University of Pennsylvania

A. Exchange as Freedom

Absent the identified anomalies of incapacity, duress, fraud, et cetera, the transactions entered into by the parties should be respected and enforced. In other words, our hypothetical person representing the law should step aside and not intervene in the bargaining process except to ensure a real and voluntary agreement. Fried declares, “Parties enter into contractual relations with certain expectations; for the state to disappoint those expectations is on *its* part a form of tyranny and deception.”⁴⁸

A choice, such as whether to enter into a market transaction, is an exercise of freedom. Transactions are a genuine representation of one’s liberty as a market

⁴⁷ University of Pennsylvania Almanac, *Ceremonial Symbols and Objects*, Oct. 19, 2004, http://www.upenn.edu/almanac/volumes/v51/n08/inaug_symbols.html.

⁴⁸ PROMISE, *supra* note 31, at 91.

participant. Each exchange demonstrates and expresses an individual's freedom to barter goods, to pursue and acquire items that he cannot produce himself, to satisfy wants and needs that he determines, and to make decisions based on a priority of needs with his individual conception of the good in mind. Moreover, men and women of all belief systems and backgrounds may participate in the market, as long as they respect the equal right of participation enjoyed by others. Above all, these people—with their own metaphysical, superficial, or political differences—are free individuals who can congregate despite this rich diversity. For example, a wealthy Iranian female can buy Chinese food from a Caucasian male atheist. Such freedom of exchange manifests choice, encourages solidarity, and promotes diversity. In short, the market itself is a product of people's freedom to choose and exchange as they wish. It is an extension of liberty providing members of society with the continuous and almost unadulterated ability to exercise their individual freedom.

The essential reason why individuals enter into transactions and contracts is that one consumer requires or wants goods that he cannot produce himself, and is willing to part with a possession of his own or is willing to work to obtain that good. The law as a mediating and supervising entity may not know why this person requires or wants a particular good or service, or why he is willing to sacrifice certain goods or services in order to obtain it. However, the fact that the individual has voluntarily and freely entered into the market indicates that this person desires to improve his utility, the utility of his family, or the utility of the unit he represents. As Posner writes, "Neither party would sign the contract unless he thought he would be better off as a result"⁴⁹ When he arrives to the market, he may enter into a transaction that most of us would not enter into; he may assign a value or ask for a price that we may not agree with. However, it is not the law's function to second-guess or judge a participant's actions when they are voluntary and free. The role of an umpire or supervisor is different from that of a third-party injecting his own subjective value as if he were the actual participant. We may not know why a consumer wishes to bargain so hard for pink fabric, even though he could obtain fabric with other attractive colors more cheaply. Perhaps he wishes to give this fabric to his daughter (who prefers pink) for her birthday, or perhaps he knows of a person in another region who would be willing to pay even more for this same fabric. We simply do not know.

The respect society affords to people to barter in the market as they please (absent the aforementioned exceptions) parallels the respect that the participants must give each other. Accordingly, the law should not disturb participants' freely chosen transactions. The respect for other parties to bargain (i.e., members of

⁴⁹ JURISPRUDENCE, *supra* note 7, at 388.

society are allowed to bargain) and the respect we ask of other participants (i.e., we should not be disturbed when we do bargain) are just as important as the honor we must conduct ourselves with (i.e., I should not complain if the transaction does not turn out favorably). A party to a transaction may not afterwards ask to be relieved from the folly of his choices. He has asked for the freedom to contract and has entered into the contract with the expectation that he will profit from the interaction. If this expectation proves to be unfounded, it is not anyone else's duty to remedy these disappointed expectations. Plainly, the individual has assumed the risk of his own endeavors. Fried writes that "[o]thers must respect our capacity as free and rational persons to choose our own good, and that respect means allowing persons to take responsibility for the good they choose."⁵⁰ More bluntly, he states, "[W]hat we achieve [is] our own and our failures [are] our responsibility too"⁵¹

B. Immorality of Breaching a Contract

According to Professor Peter Linzer, "'Morality' stands for the idea that it is both fair and appropriate to hold people to promises that they freely made."⁵² This is because the party in breach voluntarily entered into a contract with another individual. As Fried notes, "The moral force behind contract as promise is autonomy: the parties are bound to their contract because *they have chosen to be*."⁵³ In other words, the parties' contractual obligations are "self-imposed,"⁵⁴ and the party in breach not only foresaw reliance, but *invited it*.⁵⁵ "To renege [on a promise] is to abuse a confidence he was free to invite or not, and which he intentionally did invite."⁵⁶

Fried's view of a contract is that the individual has expressed his autonomy in seeking out a contract, and has willingly entered into an agreement. Therefore, by entering into a contract, he has committed himself, or more specifically his will, since

⁵⁰ PROMISE, *supra* note 31, at 20.

⁵¹ *Id.* at 8.

⁵² Linzer, *supra* note 17, at 112.

⁵³ PROMISE, *supra* note 31, at 57 (emphasis added).

⁵⁴ *See id.* at 2.

⁵⁵ *Id.* at 11.

⁵⁶ *Id.* at 16.

“persons may impose on themselves obligations where none existed before.”⁵⁷ Based on this principle of autonomy, it is immoral for a party to breach a contract since he sought to benefit from the bargaining process or a formal contract in the first place.⁵⁸

Fried is undoubtedly correct that it is inappropriate for a person to “back out” of a contractual relationship that he willingly made. As noted before, individuals are inherently self-interested, and an individual who comes to the market surely does so with the intention of obtaining a benefit from the transaction that he has chosen. He wishes to profit from the institution of the market, yet in breaching a contract, he is not only failing to honor a commitment he intentionally made and agreed to, but he is also upsetting the reasonable expectations of the other party. Thus, a party’s breach injures the market and the mechanism of contracting—the very mechanism that allowed him to attempt to gain from the exchange with others. In other words, it is dishonorable individually and degrading collectively, both to the market and to the method of securing commitments (i.e., contracts), for one party to breach a contract.

The damage to the individual is that, in breaching a contract, he is breaking his word, a commitment he voluntarily made. In so doing, he has demonstrated that he values personal gain over social cooperation⁵⁹ and mutual respect. Again, one who breaches a contract possesses a “bias . . . in favor of individual, uncooperative behavior as opposed to behavior requiring the cooperation of the parties.”⁶⁰

Gary Akerlof’s writings explain the damage that breaches impose on the market and the incentives for contracting.⁶¹ Breaches undermine market participants’ confidence that an obligor will actually keep his commitment when the time for performance arrives. The value of a contract will decrease because each

⁵⁷ *Id.* at 1.

⁵⁸ *See id.* at 17, 20.

⁵⁹ *See* PROBLEMATICS, *supra* note 14, at 108 (stating that law and morality “are parallel methods . . . for bringing about the kind and degree of *cooperation* that a society needs in order to prosper” (emphasis added)).

⁶⁰ Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 968 (1982) [hereinafter Macneil].

⁶¹ *See generally* George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. OF ECON. 488 (1970) (explaining uncertainty’s effect on the market).

market participant will discount for the fact that the other party may or may not keep his contract. Akerlof provides used cars as an example.⁶² Individuals interested in purchasing a used car will consider, when assigning a value to each used car, whether the car may be a “good” car or a “lemon.”⁶³ Even though a car may be good (an honored contract), the possibility that it may be a lemon (a breached contract) leads one to undervalue *every* car (every contract) out of fear that one may end up with a lemon (a breached contract).⁶⁴ Accordingly, the sale of each lemon (a breach of contract) undermines the confidence of used car buyers and dealers (market participants) in the integrity of the relevant market.

Legal scholars with a moralistic perspective who object to the doctrine of efficient breach adopt the general approach of the previous section,⁶⁵ but take the analysis one step further. To these individuals, it is “immoral” or “wrong” to disturb an exchange outside of a few recognized exceptions, even if in doing so the breaching party (and ostensibly society) will be able to benefit from the second, more lucrative contract. For example, Professor Linzer writes, “It seems *right* that people who make fair bargains should be held to them. Absent unconscionability, incapacity, or a like excuse, it should be *wrong* to break a contract. . . . More important, it is simply *right* that one get what he was promised.”⁶⁶ Fried, while agreeing with these commentators that a breach of contract is immoral, frames the argument in terms of the libertarian concepts of commitment, reliance, and voluntarily binding one’s will.⁶⁷ However, the implications of Fried’s comments, revealed by the explicit language of scholars like Linzer, make the moral argument against efficient breaches more amenable to attack from the law and economics

⁶² *Id.* at 489-92.

⁶³ *Id.* at 489.

⁶⁴ This fear is explained by the fact that people are risk averse, meaning they “dislike the uncertainty” about losses and the magnitude of the losses. STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 186 (1987).

⁶⁵ *See supra* Part III. A.

⁶⁶ Linzer, *supra* note 17, at 111, 138 (emphasis added).

⁶⁷ However, Fried’s writing is not entirely free of strong moralistic references. For example, Fried states, “If I make a promise to you, I should do as I promise; and if I fail to keep my promise, it is *fair* that I should be made to hand over the equivalent of the promised performance.” *PROMISE*, *supra* note 31, at 17 (emphasis added).

school. Arguing that it is “immoral” or “wrong” to breach a contract may be a more pronounced expression of the view that it is dishonorable to break one’s word.⁶⁸

C. Regret

Perhaps what is most frustrating to the critics of the efficient breach doctrine is that the breaching party is trying to benefit from a breach of a prior obligation. In other words, the breaching party agreed to a contract at time x , yet is breaching at time $x+1$, despite the fact that he voluntarily and freely bound himself at time x . If the breaching party realizes that the new contract opportunity is potentially more profitable, either he should have entered into this contract in the first place (assuming he knew about the more profitable contract), or he should have waited and not bound himself at time x (assuming he did not know about the more profitable contract).⁶⁹ The inappropriateness of an efficient breach is thus that the party in breach is attempting to “recapture opportunities foregone upon contracting.”⁷⁰

When a party breaches in order to pursue a more profitable contract, he is indicating that the “cost of performing . . . diverge[s] significantly from the [opportunity] cost that [he] estimated when making the promise.”⁷¹ In other words, a party in breach experiences *regret*, which is defined by Professor Louis E. Wolcher as:

⁶⁸ The former expression may be derived from a system of values where a contract is a “promise,” while the latter may be traced to a medieval understanding that one’s word is one’s bond; the former would thus violate values probably thought to be timeless and likely to be shared by many, while the second would violate an individual’s honor.

⁶⁹ While the breaching party can address this inadequacy by offering to negotiate a release or settlement, or by sharing the profits with the non-breaching party, he is by no means required to do so under the doctrine of efficient breach. He is merely required to pay a compensatory sum, which is determined by the courts or by a liquidated damages clause if the parties agreed to one at contract formation. In short, the breaching party will likely breach and wait for the non-breaching party to sue for damages, rather than approach the non-breaching party to negotiate a release of some sort.

⁷⁰ Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 373 (1980). This inappropriateness is particularly acute since the non-breaching party to the original contract is not completely compensated by existing contract remedies, a contention to be discussed *infra*.

⁷¹ Louis E. Wolcher, *The Accommodation of Regret in Contract Remedies*, 73 IOWA L. REV. 797, 799 (1998).

[T]he feeling one experiences in hindsight after making a decision that harms one's own interests. . . . Regret . . . says, in effect, "I wish I had made a good deal, but now that I see that I made a bad one [because there is a more profitable deal out there], I wish I could get out."⁷²

An efficient breach, then, is an attempt by the breaching party to transform an emotive response to a forgone deal (regret and an indifference to the welfare of the non-breaching party) into a legally sanctioned right to recoup a more profitable opportunity, even though the breaching party is already bound.

In entering the market, each participant believes that he will benefit from the exchange he engages in, even if he might be uncertain as to whether he will actually benefit. In other words, he is taking a risk, much like in the stock market, that an anticipated gain will materialize into an actual gain. One also assumes the risk that an anticipated gain may prove to be an unfortunate loss—all investments do not end up favorably. "Every decision, including the decision to enter into an agreement, produces the opportunity for . . . regret simply because things may not turn out as one anticipated when making the decision."⁷³ The market permits men to take such risks and provides them with the *opportunity* to profit; it offers no assurances that such a profit will ensue.

A breach is an attempt to escape the responsibility of having assumed the risk of an unfavorable result, and the responsibility to honor an obligation voluntarily undertaken. The efficient breach theory would allow a party to revisit the decision he previously made and undo his commitment—or renege on his word—as long as the breaching party could reap a profit that exceeded the non-breaching party's loss. The virtues of social cooperation and reciprocal gain that undergird the market are degraded when an individual severs a contract for unilateral gain.⁷⁴ In other words, both parties enter into a contract so that they can profit off of each other,⁷⁵ yet an efficient breach serves only self-interest and destroys this mutuality.

⁷² *Id.* at 799-800.

⁷³ *Id.* at 799.

⁷⁴ *Id.* at 837 ("The efficient breach is an economic tool for the *unilateral* reallocation by the promisor of resources that seem to belong to the promisee." (emphasis added)).

⁷⁵ Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237, 241 (1981) (stating that "parties do not enter into agreements which do not benefit them").

The suggestion that an efficient breach is an improper attempt to convert regret into a permissible “way out” is reminiscent of Plato’s *Crito*, where Socrates was advised to flee rather than be executed. He refused, noting that individuals in a city-state are:

[A]t liberty to leave the city . . . if our covenants appeared to you to be unfair. You *had your choice*, and might have gone [to another state] . . . Any of you who does not like us and the city . . . may go where he likes, and take his goods with him. But he who has experience of the manner in which we order justice and administer the State, and still remains, has entered into an implied contract that he will do as we command him.⁷⁶

Similarly, each party to a contract knew the terms of the contract (analogous to the laws of a city, the difference being the party to a contract voluntarily and knowingly negotiated the terms, rather than just merely accepting or acquiescing to them), had the choice to leave (i.e., not enter into the contract) and go anywhere he wishes (i.e., enter into any number of possible contracts). Accordingly, a party to a contract who has willingly remained (i.e., entered into the contract and attempted to avail himself to the possible benefits thereof) cannot later complain and attempt to escape from the terms, conditions, or provisions that he explicitly (as opposed to implicitly in the case of Socrates) accepted.

D. Posner’s Reply

Like Holmes, Posner is a pragmatist; as such, he contends that the law must be more scientific (i.e., more closely rooted in facts drawn from actual experience and observation).⁷⁷ Specifically, Posner posits that the law, or more appropriately judges who render decisions, should be “practical, instrumental, forward-looking, activist, empirical, skeptical, antidogmatic, experimental.”⁷⁸ Pragmatists are concerned mainly with drawing closer to the truth. Morality, however, is not scientific and does not lead us closer to empirical truth, since morality is about values, not facts.⁷⁹ Since moral sentiments are essentially one’s judgments and are

⁷⁶ PLATO, *Crito*, in DIALOGUES OF PLATO 41, 50-52 (Benjamin Jowett trans., The Colonial Press rev. ed. 1900) (emphasis added), available at <http://classics.mit.edu/Plato/crito.html>.

⁷⁷ See James R. Hackney, Jr., *The “End” of: Science, Philosophy, and Legal Theory*, 57 U. MIAMI L. REV. 629, 642-43 (2003).

⁷⁸ PROBLEMATICS, *supra* note 14, at 252.

⁷⁹ See JURISPRUDENCE, *supra* note 7, at 351.

not about facts, “moral philosophy . . . enriches; it neither proves nor edifies.”⁸⁰ Morality, to Posner, will not lead to any improvement in jurisprudence.⁸¹

Moral arguments, thus, preach to the converted, and debate over moral issues only reinforces or strengthens the veracity of one’s beliefs; it does not draw one any closer to objective certainty.⁸² In sum, Posner does not believe that moral considerations have any relevance in the law, since morality is a statement of one’s preferences that entrenches rather than eliminates uncertainty, that is unverifiable, indeterminate, relative, and so general as to be effectively irrelevant in particular legal disputes.⁸³

Despite this, members of society often rely on morality with the belief that they are “right” or that morality is capable of progressing towards empirical truth. As a result, individuals hold onto moral claims very strongly. The problem, as addressed by Posner, is that if *each* individual believes that his moral perspective is correct, we have moral heterogeneity (i.e., more answers) rather than clarity (i.e., fewer answers).⁸⁴

This problem is particularly intense in the United States, since this society promotes and encourages the expression of different values, belief systems, religions, et cetera. Accordingly, Posner declares that in a morally heterogeneous society such as this one, moral debates will be indeterminable.⁸⁵ The more moral judgments we

⁸⁰ PROBLEMATICS, *supra* note 14, at 32.

⁸¹ *See id.*

⁸² *See id.* at 90.

⁸³ *See id.* at 42.

⁸⁴ *See* Richard A. Posner, *The Problematics of Moral and Legal Theory*, 111 HARV. L. REV. 1637, 1656 (1998) (recognizing “moral pluralism within the United States” and stating generally that “[t]he acceptability of a moral principle is inverse to its capacity to resolve an actual issue.”) [hereinafter *Moral and Legal Theory*].

⁸⁵ *See* Richard A. Posner, *The Jurisprudence of Skepticism*, 86 MICH. L. REV. 827, 861 (1998) (noting that “with the decline of authority a community becomes morally heterogeneous, to the point where people may come to inhabit incommensurable moral universes within the same political community,” citing “the situation of the pro-abortionists and the anti-abortionists in [the United States] today” as an example of one that “seems to admit of no rationally demonstrable resolution”).

have in this society, the more this heterogeneity will be revealed, and the more distant all participants will be from any improvement in their value judgments.⁸⁶

Considering Posner's general reaction towards morality, he would likely claim that the assertions that an efficient breach is "immoral," "wrong," or "unfair" are merely restatements of one's value judgments, public opinion,⁸⁷ or political preferences.⁸⁸ Most importantly, he would state that these value judgments should be of no concern to judges since moral statements cannot be reduced to verifiable statements of fact, and, therefore, cannot produce differences in behavior. The law is obeyed, as Holmes noted, because of sanctions, not necessarily because there is a duty to do so, or because they are just.⁸⁹ Thus, an appeal to one's conscience will not deter or prevent efficient breaches from occurring.

Economics, however, can and does lead to alterations in behavior. The economic determination that a breach is "efficient" is a sufficient justification for the breach. That is, morality does little to improve the actual lives of members of society, and the consequence of moral debate is a repetition of useless discussion,⁹⁰ not the advancement of society's welfare. As noted in the "Economic Justifications" section *supra*, Posner believes that an efficient breach actually does increase society's welfare through wealth maximization—a tangible benefit to society that morality cannot controvert. We will now discuss whether the economic arguments supporting the doctrine of efficient breach are indeed sound or whether they are empty promises of an increase in social wealth.

⁸⁶ *Moral and Legal Theory*, *supra* note 84, at 1648 ("In a mutable or pluralistic moral culture, moral philosophy offers people choices of how to live, or how to think about how to live. In this it resembles, indeed might be thought a form of, art, religion, or therapy. But it is not a matter of offering reasoned answers to moral questions."). More choices based on moral philosophy, according to Posner, will not lead to demonstrable universal truths.

⁸⁷ See JURISPRUDENCE, *supra* note 7, at 239.

⁸⁸ See *id.* at 23.

⁸⁹ See Holmes, *supra* note 6, at 459-60.

⁹⁰ See PROBLEMATICS, *supra* note 14, at 50 ("Moral theory is like a system of mathematics that has never gotten beyond addition.").

PART IV. ECONOMIC JUSTIFICATIONS REVISITED

*A model assuming away relations slips with the greatest of ease at any state into favoring uncooperative and—ironically enough—highly inefficient human behavior.*⁹¹

- Professor Ian Macneil

A. The Inefficiency of an “Efficient” Breach

The principal economic rationale for an efficient breach is that such a breach offers more wealth to society, to the breaching party who can obtain a better deal, and to the party who engages in the new contract with the breaching party. An examination of the economic justifications for an efficient breach reveals that this economic rationale is faulty. In addition, while we can conceive of a hypothetical breach that may be efficient, an efficient breach is not likely to occur in real life. As a result, even though Posner has discounted the merit of the moral objections to an efficient breach, an efficient breach is still unlikely to be efficient in real life experience. Accordingly, an efficient breach is not socially desirable or beneficial, even when the analysis conducted is purely economic.

1. Indifference of the Non-Breaching Party

One of the assumptions inherent in an efficient breach is that the compensation provided to the non-breaching party is sufficient to make him indifferent as to whether the breach occurred. In other words, in the calculus that deems a breach to be efficient, the damages paid to the promisee relieve the breaching party of any further obligation to the promisee and free the breaching party so that he can pursue other contracts.

The assumption that the non-breaching party is indifferent is important because of the various standards of efficiency, discussed *supra*, that require the victim's losses to be offset by the action. For example, in the Pareto superior measure of efficiency, no one may be made worse off by a transaction if it is to be efficient.⁹² Also, in the Kaldor-Hicks measure of efficiency, a move is efficient if the breaching party is better off even after compensating the non-breaching party.⁹³

⁹¹ Macneil, *supra* note 60, at 969.

⁹² See *supra* text accompanying note 18.

⁹³ See *supra* text accompanying note 19.

These measures of efficiency include an element of compensation (by the non-breaching party being compensated so he is not worse off) that is commensurate with the compensatory goal of contract law remedies. Thus, the damages that a promisee receives are considered to be sufficient to offset his financial losses, either by placing him where he would be had the contract been realized (expectation damages)⁹⁴ or where he would have been before the contract was made (reliance or restitution damages).⁹⁵ Yet none of these three contract remedies provides a “compensatory sum”⁹⁶ that will make the promisee indifferent. Indifference in the promisee, not compensation to the promisee, is what is required to sufficiently offset the financial losses or reasonable expectation of the promisee. Professor Mark Seidenfeld writes, “An economic change is Kaldor-Hicks efficient if the new outcome makes those who benefit sufficiently well off that they would still end up with an increase in utility even if they compensated the losers *enough to make the losers indifferent.*”⁹⁷ There is a fundamental difference between indifference and compensation, and while contract remedies address the latter, it is only the former that will permit the non-breaching party to be adequately “paid off” so that he is not “worse off” and so that his interests are fully made up for.

For example, Harold Demsetz discusses what regime of liability would be appropriate where two actors can both exercise due care in avoiding an accident, such as a driver or a pedestrian on the road.⁹⁸ Demsetz writes that if drivers are held liable, they will obviously avoid accidents.⁹⁹ However, the incentive for pedestrians to avoid the accidents is decreased because, if drivers are held liable, pedestrians will be compensated regardless of whether they are careful or not.¹⁰⁰ This assumes, however, that pedestrians are indifferent towards an accident with compensation

⁹⁴ See Kevin E. Davis, *Promissory Fraud: A Cost-Benefit Analysis*, 2004 WIS. L. REV. 535, 537 (2004) (defining expectation damages as a “measure of damages that will put the promisee in the position he would have been in if the contract had been performed”).

⁹⁵ See L. L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 YALE L. J. 52, 54 (1936).

⁹⁶ Holmes, *supra* note 6, at 462.

⁹⁷ MARK SEIDENFELD, MICROECONOMIC PREDICATES TO LAW AND ECONOMICS 54-55 (Anderson Publ'g Co. 1996) (emphasis added).

⁹⁸ Harold Demsetz, *When Does the Rule of Liability Matter?*, 1 J. LEGAL STUD. 26-28 (1972).

⁹⁹ *Id.* at 26.

¹⁰⁰ *Id.*

versus no accident. A cursory examination of this particular situation should reveal that anyone in the pedestrians' circumstance, even if drivers were held to a strict liability standard, would not be indifferent to an accident with compensation versus no accident; everyone would choose no accident.

Similarly, with a breach of contract, a party to a contract will not be indifferent to a breach and compensation versus having full performance. How is it that the contract remedies are not sufficient to make one indifferent? Indifference is very easy to ascertain. It is a sum that one would propose when asked, "What could I pay you in order for you not to care that I breached the contract, even if you incurred reliance costs and expected me to perform?" A payment of this sum, and only this sum, will be sufficient to make the promisee indifferent. Yet, this sum is not guaranteed to be, and likely will not be, the compensatory sum that the courts will provide to the non-breaching party.

To continue with Demsetz's example, suppose I am a pedestrian who is hit by a car and the driver of the car is held strictly liable for the accident. Assume further that I suffer a broken leg and as a result I miss three days of work. I sue the driver for the medical costs, the loss of wages from these three days of work, and emotional suffering from having to endure this life-threatening and painful experience. The sum, to be ascertained by the courts, will be relatively fixed and based on the actual medical costs (say, \$1,000), three days of wages (say, \$500), and emotional trauma (say, \$3,000). The total sum is thus \$4,500. If I were asked, "How much money would it take to make you indifferent to being in the accident?" That sum would surely be higher than my fixed costs and emotional trauma; it would surely be higher than \$4,500. Accordingly, a compensatory sum is not the same as an indifference sum. It is possible for one's indifference sum to be lower than a compensatory sum; however, contract law remedies do not ensure that a compensatory sum will include an indifference sum. As a result, a non-breaching party can, and most likely will, be worse off by a breach (Pareto superior), and a breaching party may not be better off after paying an indifference sum to the non-breaching party, as opposed to paying a compensatory sum (Kaldor-Hicks).

Liquidated damages¹⁰¹ represent a way in which a breach can meet the condition of "promisee-indifference." For example, suppose A agrees to deliver 45,000 widgets to B in nine months for an important convention that B is attending.

¹⁰¹ Liquidated damages are agreed to by the parties at the time of contract formation and are incorporated into the contract as a provision that specifies the amount of relief if a breach is to occur. Larry A. Dimatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 633 n.1 (2001) ("Liquidated damages refer to a provision in a contract in which the parties agree to prevent litigation on the issue of damages in the event of breach.").

If B has these widgets at the convention, he may be able to resell them for a large profit of \$200,000. The contract price agreed to is \$15,000. A, however, feels that he may be able to procure a more favorable delivery contract for the same 45,000 widgets, perhaps a \$35,000 contract with C. Since A is not sure that such a more lucrative contract will materialize, he binds himself to the present contract with B for \$15,000. A may attempt to negotiate for a liquidated damages clause since there is a possibility he would have to pay B's \$200,000 expected profits from the delivery and resale. B may be willing to negotiate for a smaller amount of assured damages because he realizes that A may breach for a better opportunity, yet understands that if A is to breach, he would like A to breach sooner rather than later so that he will have more time to find a replacement deliverer (so that he can realize the \$200,000 expected profit from the convention).

A and B can negotiate a favorable liquidated damages sum that will alleviate the concerns of both parties. One possible sum might be the contract price plus \$3,500 for each month that passes. Therefore, if A breaches a minute after contract formation, he would pay \$15,000 + \$3,500 (\$18,500), which will allow A to realize a better opportunity since \$18,500 is lower than the \$35,000 that C may offer. Yet, if A breaches in nine months, say a week before performance is due, he would have to pay \$15,000 + \$31,500 (\$46,500), which is greater than the \$35,000 that C may offer; thus, he would not pursue this contract.¹⁰² B has thus negotiated a liquidated damages sum that induces A to breach early on, if at all. Since the liquidated damages increase each month, after the fifth month it would no longer be attractive for A to breach; this is good for B since it would be harder to find a replacement after that point. And, in case A did breach, B would obtain more money that could defray any reliance costs.

Because the foregoing clause institutes a graduated set of damages based on a reasonable calculation of potential harm, it should satisfy the standards set forth by Posner in his discussion of liquidated damages provisions:

When a contract specifies a single sum in damages for any and all breaches even though it is apparent that all are not of the same gravity, the specification is not a reasonable effort to estimate damages; and when in addition the fixed sum greatly exceeds the actual damages likely to be inflicted by a minor breach, its character as a penalty becomes unmistakable.¹⁰³

¹⁰² Mr. Bo Howard (J.D. 2003, The George Washington University Law School) and I created this hypothetical during a negotiating exercise.

¹⁰³ *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1290 (7th Cir. 1985).

Perhaps most important is that a liquidated damages provision would assuage the concerns of the moral scholars. Both parties have agreed to a liquidated damages clause, such as the one just described. As a result, the virtues of cooperation, reciprocity, and mutuality are preserved. Thus, there is no element of surprise or regret since such possible future responses are accommodated and accounted for in the contract.

These considerations will still not satisfy some moral scholars who subscribe to the belief that a breach of contract is still “wrong,”¹⁰⁴ and is most abhorrent when the breach is for economic gain. Moreover, liquidated damages provisions are not warmly received by the courts. As contract remedies are designed to compensate, a liquidated damages provision that appears to be punitive will not be enforced.¹⁰⁵ Finally, it is possible that a liquidated damages provision cannot be negotiated since the promisee will not want the other party to breach at all; he can achieve this either by not agreeing to any provision, or by agreeing to a liquidated damages amount that is exorbitantly high such that the opportunity to breach in order to pursue a more profitable contract is foreclosed.

Even so, liquidated damages may represent the best way to reconcile members of the law and economics school and moral scholars. As the parties negotiate such a clause, the promisee will bargain for an amount that will make him indifferent to a breach, so the promisee can allow the promisor to breach for a more profitable contract.

2. Transaction Costs

One of the reasons a compensatory sum is insufficient to offset the losses of the non-breaching party is that it is not the same as the indifference sum. In addition, a compensatory sum fails to take into consideration the transaction costs incurred by the non-breaching party. For example, in our accident example, if I am provided with \$4,500 for the accident (which is not sufficient to make me indifferent as to the accident with compensation versus no accident), the \$4,500 does not compensate me for the transaction costs I suffered, such as the costs of suing the breaching party.

¹⁰⁴ Linzer, *supra* note 17, at 111 (“Absent unconscionability, incapacity, or a like excuse, it should be *wrong* to break a contract.” (emphasis added)).

¹⁰⁵ See RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981).

Accordingly, transaction costs are likely to prevent most breaches from being efficient, even in the Pareto optimal sense. Transaction costs can render a breach that one thought to be efficient into one that is not profitable or socially beneficial. For instance, in our example with the liquidated damages provision, if A breached its contract with B during the first month and forfeited \$18,500, then entered into a second contract for \$30,000 (for a net gain of \$11,500), the transaction costs incurred by the breaching party, the promisee, and the third party may be greater than \$11,500, thus negating A's individual gain and decreasing social wealth.

The first category of transaction costs arise during the negotiations—when a party is attempting to figure out if another party is likely to breach, and where a party will engage in more stringent bargaining over the terms of the contract. These transaction costs arise out of what Akerlof termed the “Market for Lemons,”¹⁰⁶ and affect all market participants since a contracting party cannot be certain who will be a party prone to breach (a “lemon”) or who will honor his word (a “good car”). Breaches, then, cause *all* market participants to lose faith in the contracting process and thus in the market mechanism itself, a loss that translates into greater transaction costs when contracting partners are sought and when negotiation commences.

A related cost is to the breaching party himself, who will likely suffer damage to his reputation. Following the breach, when market participants are looking for parties to contract with, they will not be as willing to bargain or negotiate with a party who has previously breached a contract where the reasons were entirely within the breaching party's control. Moreover, even if a party takes the risk with a person or a corporation who has deliberately breached before, that party may negotiate for more onerous terms to ensure there will not be a breach.

Other transaction costs involved deal with the breach itself, namely the expenses incurred by both parties in resolving their dispute through negotiation, arbitration, or litigation; the promisee's costs in finding another person to provide the goods or services required; and the breaching party's expenses in negotiating the new contract with the third party offering a more profitable deal. The litigation costs can be significant, especially if there is evidence of “bad faith” between the parties (as a breach would evince). One would expect such proceedings to be particularly adversarial (e.g., during discovery motions). Professor Ian Macneil explains that a party in breach

pays no attention to the transaction costs of talking after a breach. And this is so despite the fact that “talking after a breach” may be

¹⁰⁶ See *supra* text accompanying notes 62-64.

one of the more expensive forms of conversation to be found, involving, as it so often does, engaging highpriced [sic] lawyers, and gambits like starting litigation, engaging in discovery, and even trying and appealing cases.¹⁰⁷

3. Externalities

One of the hallmarks of the study of economics is the recognition that externalities are per se inefficient. An externality occurs “[w]hen an individual bears part of the benefits or part of the costs of his precaution.”¹⁰⁸ “[T]he incentives of private individuals are socially efficient when costs and benefits are fully internalized, whereas incentives are inefficient when some costs and benefits are externalized.”¹⁰⁹

When a party in breach considers whether or not he should breach, he does not consider the number of costs that are borne by society and others if he does breach. For example, breaches will almost certainly lead to litigation or other dispute resolution mechanisms so that the promisee can obtain compensation. However, the litigation costs of the promisee are borne by the promisee. The “American Rule” governing attorney’s fees, which states that each party generally bears its own expenses of litigation,¹¹⁰ prevents these litigation costs from being properly assigned to the breaching party so that these costs can be internalized. Also, the party in breach does not consider the costs to society, which are elucidated by Akerloff.¹¹¹ When a party breaches, other participants in the market will endure costs in determining whether other parties may breach, and they thus may discount the value of the contract. This discounted value will not mirror the efficient price in a market, as a price should ideally be set where marginal cost (supply) equals marginal utility (demand).¹¹² Thus, there is a deadweight loss to society. Moreover, as a compensatory sum is not equivalent to an indifference sum, incomplete

¹⁰⁷ Macneil, *supra* note 60, at 968-69.

¹⁰⁸ Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 3 (1985) [hereinafter *Unity in Tort*].

¹⁰⁹ *Id.*

¹¹⁰ *See Preferred Mut. Ins. Co. v. Gamache*, 686 N.E.2d 989, 991 (1997).

¹¹¹ *See supra* text accompanying notes 62-64.

¹¹² *See* Patrick B. Crawford, *The Utility of the Efficiency/Equity Dichotomy in Tax Policy Analysis*, 16 VA. TAX REV. 501, 522 (1997).

compensation will result in an externality borne by the promisee. When compensation is imperfect, the other party will bear some of the cost.¹¹³

These considerations, especially the transaction costs and the externalities imposed on parties other than the decision-maker, as well as on future market participants, indicate that the theory of efficient breach is not likely to be realized in actual experience.

B. Internalizing the Costs

1. Holmes' "Bad Man"

The notion that the law ensures the integrity of the market (e.g., by guarding against fraud or contracts made under duress) implies that sanctions must be applied to discourage antisocial behavior. In economic terms, sanctions add to the cost of socially undesirable behavior that is likely to impose an externality on society (e.g., pollution or stealing what is not one's own). Sanctions thus act as a deterrent because the penalty (e.g., a fine or punishment) forces the actor to consider or internalize the total cost of his actions—a total cost that may be greater than the expected benefit from the behavior.

Other than finding a more profitable contract (the reward), paying a compensatory sum (the sanction) is all the party in breach has to worry about to engage in an ostensibly efficient breach. We need not worry about men whose conduct can be restrained by appeals to their conscience. However, we must be concerned with the "bad men" described by Holmes, viz., individuals who obey the law only because of the sanctions.¹¹⁴ According to Posner, law is a substitute for morality, since moral claims cannot always restrain behavior where sanctions can.¹¹⁵ Indeed, "law *backs up* morality, adding temporal sanctions to the sanctions of conscience . . ." ¹¹⁶ Thus, for Posner, the law is separate from morality due to the fact that the law is obeyed because of sanctions, not because there is a moral duty to do so.¹¹⁷

¹¹³ *Unity in Tort*, supra note 108, at 6.

¹¹⁴ JURISPRUDENCE, supra note 7, at 223-24.

¹¹⁵ *Id.* at 136-37.

¹¹⁶ PROBLEMATICS, supra note 14, at 108.

¹¹⁷ See JURISPRUDENCE, supra note 7, at 136-37.

The “penalty” or remedy for a breach of contract is usually restitution, reliance damages, or expectation damages. Because only reasonably foreseeable reliance damages are protected, expectation damages will equal the value of performance, and restitution is the value of the benefit conferred; this compensatory sum can often be estimated with reasonable accuracy by the party considering whether to breach (that is, whether the breach will be efficient).

The question then becomes, if a purported efficient breach is usually inefficient and if appealing to one’s conscience is inadequate to restrain socially undesirable behavior, then what sanctions should the law impose on the breaching party? That is, what remedies should the law entertain in order for a breach to be efficient or socially desirable?

2. Other Remedies

a. Liquidated Damages

The first damage remedy that may allow for costs to be internalized is a liquidated damages clause. As noted above, both parties negotiate a liquidated damages provision at contract formation. As a result, if a breach occurs, the allocation of costs is already determined. If the costs are greater than the liquidated damages that have been negotiated, the non-breaching party has voluntarily assumed that risk.

Despite the appeal of a liquidated damages clause, an appeal that extends to both the law and economics school and to the moral commentators, there are several problems with this remedy. First, such clauses would only address the transaction costs that may be endured by the promisor and the promisee that relate specifically to this contract. However, other market participants will still be affected if certain participants opportunistically breach. This may force more and more parties to adopt liquidated damages provisions, which would require more costly and complex negotiations. Second, liquidated damages provisions have not been favorably received by the courts. The courts will not enforce liquidated damages clauses that are deemed to be a penalty. Therefore, while a liquidated damages provision is potentially a more satisfactory remedy than restitution, reliance, or expectation damages, the courts may not enforce the provision if it is found to be penal rather than compensatory. The fact that courts may not enforce a liquidated damages provision presents a difficulty to the parties to a contract: the parties may have, in good faith, intended to negotiate a fair liquidated damages provision, yet the court may not agree that the terms are compensatory. This difficulty is especially

pronounced since, as Posner observed, there is a “fuzzy line between penalty clauses and liquidated-damages clauses.”¹¹⁸

b. British Rule

The promisor and promisee both bear the costs of litigation when a breach occurs. The promisor, in the calculus of an efficient breach, does not consider the litigation costs of the promisee. One way to require the promisor to internalize this externality would be to adopt the “British Rule,” which requires the loser to pay the litigation costs of both parties.¹¹⁹ If a liquidation damages provision was enforced along with the “British Rule,” the promisor would internalize more of the costs, and a breach would be more efficient than it is under the current rules. However, some inefficiency could still occur because, *inter alia*, the reputational costs of both parties and the costs to other market participants would still remain. It would appear that adopting a joint regime of upholding liquidated damages clauses and applying the “British Rule” would significantly reduce the inefficiency that results from a breach of contract.

c. Specific Performance

It has been argued with some considerable force “that in the absence of stipulated remedies in the contract that survive scrutiny on the usual formation defenses, specific performance is more likely than any form of money damages to achieve efficiency in the exchange and breach of reciprocal promises.”¹²⁰ Specific performance is a judicial decree “requiring the promisor to perform his contractual promise or forbidding him from performing the promise with any other party.”¹²¹ Thus, in our first example from Part I, A would have to deliver the widgets to B, because it will be prevented from delivering them to C. Thomas Ulen suggests that a decree of specific performance “should be understood as an instruction to the litigants to use the market, rather than the court, to solve their dispute.”¹²² In other

¹¹⁸ Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1286 (7th Cir. 1985).

¹¹⁹ See Keith N. Hylton, *An Asymmetric-Information Model of Litigation*, 22 INT’L REV. L. & ECON. 153, 154 (2002) [hereinafter Hylton].

¹²⁰ Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 343 (1984) [hereinafter Ulen].

¹²¹ *Id.* at 364.

¹²² *Id.* at 399.

words, a decree of specific performance is actually an order to A and B that they should negotiate a proper settlement or release on their own, outside of the courts.

Therefore, it is contended that specific performance will promote greater efficiency for three reasons. First, Ulen argues that if the promisor and promisee “are on notice that valid promises will be specifically enforced, they will more efficiently exchange reciprocal promises at formation time. . . . Second, and perhaps most importantly, specific performance offers the most efficient mechanism for protecting subjective values attached to performance”¹²³ Finally, the parties will negotiate after the breach to resolve the dispute on their own, rather than requiring the courts to calculate damages.¹²⁴

The second reason explains why the first is not compelling under the current legal regime. Specific performance is generally granted only when damages are inadequate¹²⁵ and the decree will not result in unfairness to either party.¹²⁶ In other words, courts are reluctant to grant specific performance. As a result, if parties understand that specific performance will only be ordered in exceptional circumstances, they will not have an added incentive to negotiate for more efficient exchanges of promises when the contract is formulated. Thus, while the second reason is true, it will only be realized in those instances where the courts find damages to be inadequate (e.g., when there is a unique product or an idiosyncratic value that cannot be adequately compensated for), which is a narrow subset of contract cases. Accordingly, the parties will not guard against a possible decree of specific performance when they create the contract.

The third claim of efficiency is not persuasive for an entirely separate reason. Ulen states, “There may be a very high probability of noncompliance, owing, perhaps, to the breacher’s having forcefully and convincingly indicated his refusal to comply.”¹²⁷ It is this same rationale that explains why negotiation after a breach will be problematic. Since a party, through breaching, has indicated he would rather pursue his unilateral financial interests than honor his commitment to the promisee, it is unlikely that the parties will be able to reach an agreement on the promisee’s

¹²³ *Id.* at 365.

¹²⁴ *Id.* at 399-400.

¹²⁵ *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 359-60 (1981).

¹²⁶ *See id.* at § 364.

¹²⁷ Ulen, *supra* note 120, at 398.

damages without significant costs (as parties who are not in accord as to performance will be unlikely to agree on damages without difficulty).

Moreover, Ulen states that while a decree of specific performance “gives the breacher a much better bargaining position in the post-breach negotiations than would be the case under a contract in which the quality of the breacher’s performance was not solely in the breacher’s hands,”¹²⁸ such increased bargaining power may result in (1) extortion, since the promisee may negotiate and say “offer me more money or else I will opt for performance,” or (2) the promisee not negotiating at all since he would prefer performance (due to his subjective valuation of performance or its uniqueness). An efficient breach will not result in either case. In the first scenario, the promisee can make a settlement so expensive as to preclude the breach from being efficient, which he can do with little effort since he has the upper hand. In the second scenario there would be no breach. If the promisor actually performed, there would be significant costs to the judicial system to supervise the performance, whether this supervision is conducted by a special master or by other appointed official.¹²⁹

d. Sharing of Profits

The parties could negotiate to share the profits from the efficient breach, or the courts could order the party in breach to surrender some of his gain to the promisee. Professor Farnsworth has suggested that the parties should negotiate on their own to split the proceeds from an efficient breach.¹³⁰ Thus, the promisor should say to the promisee, “It would be to our mutual advantage to negotiate a release to permit me to sell the widget to the second buyer at a profit, which you and I could divide.”¹³¹

This idea is reminiscent of our discussion of specific performance and Ulen’s notion that a decree of specific performance is actually an implied order to the parties to negotiate a solution on their own. A release that would result in the sharing of the profits from an efficient breach is one possible solution that the promisor and the promisee can negotiate. However, this type of release or settlement is still amenable to the criticisms we levied against the negotiations that

¹²⁸ *Id.* at 400.

¹²⁹ *See* RESTATEMENT (SECOND) OF CONTRACTS § 366 (1981).

¹³⁰ Farnsworth, *supra* note 26, at 1380-81, 1381 n.147.

¹³¹ *Id.* at 1381 n.147.

may result after a decree of specific performance (e.g., negotiations will be arduous due to the strained relations between the parties, and the promisee may demand performance rather than money).

Fraud, dishonesty, and strategic behavior can all act to preclude the sharing of profits from being truly fair or without significant costs to either side. For example, the promisor may exaggerate his own costs and understate the expected profits from the second contract, while the promisee may exaggerate his reliance costs and expected profits from the original contract. Moreover, the externalities after the breach to the future market participants and to the parties when they attempt to reenter to market are still left unresolved if the two parties share profits.

Aside from a court granting specific performance and implying that the parties should negotiate a settlement, a judge could order the breaching party to disgorge part of his profits to the non-breaching party. Perhaps restitution would provide the basis for such a novel remedy, as this form of remedy would hold that the breaching party unjustly benefited from the non-breaching party while simultaneously making him worse off. Since the difference between the breaching party and the non-breaching party is two units (gain to the former *and* loss to the latter), a payment of restitution would aim to even out the unjust enrichment by requiring the breaching party to pay damages to the non-breaching party.

While the basis for this suggestion is arguably grounded in restitution, the remedy of disgorgement is a significant departure from the accepted contract remedies. Restitution requires a breaching party to compensate the non-breaching party for the value of the benefit conferred so that the non-breaching party can be returned to the *status quo ante*. If the breaching party were to share part of his profits with the non-breaching party, this would likely exceed the actual benefit that the breaching party has received in fact from the non-breaching party. Thus, the disgorgement remedy would actually go beyond the general restitutionary principle of unjust enrichment. To be sure, the enforced sharing of profits through disgorgement would arguably require the breaching party to internalize the costs of his breach more completely and would further compensate the non-breaching party for the costs he has endured (e.g., litigation costs).

There are two possible reasons why a disgorgement remedy might not be acceptable to judges. First, contract remedies are designed to compensate, and requiring the breaching party to surrender part of his profits may be seen as a penalty. For example, another way to frame the suggestion that a breaching party share part of his profits is for the court to impose a tax on the breach by taking a certain amount that would be immediately passed to the non-breaching party. While such a tax would make breaching more costly and thus provide less incentive to

breach, this could be seen as a penalty, which would not pass judicial muster under current contract law. Second, having a party explicitly surrender profits resembles disgorgement, which is almost universally disfavored by the courts,¹³² even where the breach is intentional and done in bad faith.

Despite the infirmities of this suggestion, it should be noted that there is an element of mutuality that is implicit in having the two parties “share” profits from a breach. That is, the two parties can both benefit from an efficient breach and more of the transaction costs can be internalized. However, it is still unlikely that this solution will result in complete efficiency because, even if this remedy is granted in all possible efficient breach of contract cases, the externalities imposed on society and the contracting parties generally still remain.

e. Punitive Damages

Finally, some legal scholars have argued that courts could impose punitive damages on the breaching party when the breach is deliberate or made in bad faith. Posner, of course, opposes this suggestion; he states, “If [the breaching party] is forced to pay [punitive damages], an efficient breach may be deterred, and the law doesn’t want to bring about such a result.”¹³³ Posner also argues that “public policy does not call for an independently deterrent award beyond compensatory damages”¹³⁴ because efficient breaches can bring about an increase in social wealth.

As noted previously, punitive damages could successfully deter breaches and make them more expensive, thus leading to an internalization of certain costs that should be borne by the decision-maker. However, such a tax on the breaching party’s behavior will still not cure the externalities that breaches impose on society and on contracting parties generally. Most importantly, contract remedies are traditionally designed to compensate, not to punish. Punitive damages are per se non-compensatory, and thus will be reluctantly granted by the courts, if at all.¹³⁵

¹³² The theory is more acceptable in cases of a breach of fiduciary duty. *See, e.g., Earthinfo, Inc. v. Hydrosphere Res. Consultants, Inc.*, 900 P.2d 113 (Colo. 1995) (relying on the disgorgement theory).

¹³³ *Patton v. Mid-Continent Sys., Inc.*, 841 F.2d 742, 750 (7th Cir. 1988).

¹³⁴ *J. Yanan & Assocs., Inc. v. Integrity Ins. Co.*, 771 F.2d 1025, 1034 (7th Cir. 1985).

¹³⁵ *Freeman & Mills, Inc. v. Belcher Oil Co.*, 11 Cal. 4th 85, 94 (1995) (noting that punitive damages were only granted by the court in insurance cases).

CONCLUSION

The doctrine of efficient breach is at the forefront of the developing landscape of American jurisprudence and contract law. The emerging influence of the social sciences, especially economics, has led to considerable debate in intellectual literature and in court opinions about the efficacy of this doctrine. The extent to which one believes that the social sciences should modify or supplant traditional contract law, and morality should command or guide the law, influence where one stands on this doctrine.

The moral scholars contend that an efficient breach severs mutuality and the virtue of social cooperation because contracts that formalize exchanges are devices to serve the mutual interests of the participants and the greater society. In engaging in a contract, parties assume the risk that their expected profits might not materialize and that they might even endure a loss, while remaining bound to their contract. Proponents of the efficient breach theory, however, advocate that one should be allowed to renege on one's commitment and revisit the decision to enter into the contract in the first place. A breach in this manner degrades the very process that allows individual strangers to be better off, to satisfy their needs and wants, and increase their utility. To break one's word should offend one's conscience; it should make one ashamed that he has abused the trust of others in the name of unilateral profit. To breach for the sake of a missed opportunity, even if it can result in more money, is dishonorable. To say that society benefits financially is to ignore the very real prospect that deliberate breaches corrupt the integrity and cooperative essence of society. This moral view asks whether society gains at all with an efficient breach, and further asks why social wealth or maximization should be of greater esteem than honor, respect, trust, and mutual benefit.

In the alternative, if one does not accept this moral argument against the doctrine, we have attempted to demonstrate that the increase in social wealth promised from an efficient breach is unlikely to be realized in actual experience. There are significant transaction costs endured by the non-breaching party (e.g., litigation costs, having to find a replacement for the performance, negotiating extra hard with future market participants to guard against another breach), the breaching party (e.g., litigation costs, having other market participants negotiate more stringently to prevent a breach, the difficulty of finding a willing market participant despite one's reputation), and society generally (e.g., the situation in Akerloff's "Market for Lemons"). These externalities strongly indicate that an efficient breach in Posner's theory is not likely to be efficient. The simple calculus of subtracting the first contract amount from the second and then deducting the promisee's expected damages is not sufficient to ascertain whether the breaching party and society will be better off due to the breach.

If there is an externality not accounted for by the breaching party—the decision-maker—the question arises whether any other contract remedy can help internalize this cost so that the probability of an efficient breach is greater. While we may wish for the breaching party to internalize the costs that he imposes on others when he breaches, such a result cannot be achieved under contract law doctrine by any means that would be deemed not punitive, including actual punitive damages, a disgorgement of profits, or a liquidated damages provision that is deemed a penalty. In addition, general application of the “American Rule”¹³⁶ means that the non-breaching party will incur significant externalities in the form of litigation costs. Assuming the courts adopt one or a combination of these expanded remedies, a significant externality will still burden other market participants, who will be making contracts with the uncertainty of whether a breach will occur. It is unlikely that expanded remedies could offset the discounted value of contracts that would result from the wide adoption of the efficient breach doctrine.

Liquidated damages present the most attractive of the expanded contract remedies, since mutuality is preserved and the risks and costs are allocated by the parties themselves. However, the costs imposed on society¹³⁷ still remain and are substantial.

We have contended vigorously that there are externalities imposed on society that are not considered by the breaching party, and it may seem as if we are overstating the importance of this possible cost. However, a cursory examination of the stock market should lead one to understand the impact a few bad apples (e.g., Enron, Worldcom, et cetera) can have on all prospective investors who are fearful that another corporation may turn into a Global Crossing or Tyco. The lack of consumer confidence in corporations mirrors the possible loss of confidence potential parties to a contract may experience in other parties and in the institution of contracting itself.

Under the current contract law regime, legal scholars advocating the efficient breach theory cannot reasonably contend that it will result in wealth maximization when it is beyond question that a breach of contract creates significant externalities—degrading contracts as an instrument of social cooperation and debasing the virtues of mutuality and reciprocity that form the essence of social

¹³⁶ Hylton, *supra* note 119, at 154 (stating that American rule is where “each party pays for its own litigation costs”).

¹³⁷ These costs, for example, include discounting goods and services out of fear of breach, negotiating more rigorously for favorable terms and to prevent the other side from breaching, and deterring participants from engaging in long-term exchanges at all.

interaction and dependency. Those concerned that the doctrine of efficient breach will somehow rise in popularity should take solace in the fact that the influence of this doctrine is confined to academia, that very few courts have relied on this doctrine, and even Posner himself has not used the efficient breach theory to justify any decision, even though he has used extensive dicta to promote the doctrine.

At the very least, Posner and his colleagues should acknowledge that the efficient breach theory is unlikely to produce its promised gains in social wealth, especially because it threatens to disrupt the social institutions that are essential to the efficacy of private contracts.