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THE MITIGATION PRINCIPLE: TOWARD A GENERAL THEORY OF CONTRACTUAL OBLIGATION

Charles J. Goetz and Robert E. Scott***

THE duty to mitigate is a universally accepted principle of contract law requiring that each party exert reasonable efforts to minimize losses whenever intervening events impede contractual objectives.¹ Although applications of the mitigation principle pervade the specific rules of contract,² it is startling how many questions remain unanswered as to precisely what efforts the mitigation duty requires and what point in time the obligation arises. For example, under what circumstances does mitigation require an in-

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¹ Generations of legal commentators have observed that the term "duty" is misleading because the contract breacher invokes the failure to mitigate as a defense to reduce the damages for which he is otherwise liable rather than as an affirmative right of action. Thus, the failure to mitigate merely "disables" the injured party from recovering avoidable losses. See *Rock v. Vandine*, 106 Kan. 588, 189 P. 657 (1920); *J. Crane, Cases on Damages* 102 n.1 (1928); C. McCormick, *Handbook on the Law of Damages* 128 (1935); Farnsworth, *Legal Remedies for Breach of Contract*, 70 Colum. L. Rev. 1145, 1184 (1970). Nevertheless, because the term "duty" is both common and convenient, we will use it throughout this article.

² The doctrine of avoidable consequences, which precludes an injured party from recovering damages for losses which he reasonably could have avoided, is the centerpiece of the mitigation principle. See *infra* text accompanying notes 18-27. Other manifestations of the duty include rules that require an injured party to accept replacement performance as a cure of defective tender or that require him to accept a substantial yet defective performance together with money damages. See *infra* text accompanying notes 73-81 (cure), 114-17 (substantial performance).

jured party to deal with the contract breacher? Why does the duty to minimize losses mature only after the breach, even if the injured party became aware much earlier of a significant danger of breach and had a cost-effective opportunity to mitigate the prospective loss? Is the duty to communicate special or unforeseeable circumstances confined to the time of contracting, even where the communication of post-contract but pre-performance information might reduce costs? These and many similar questions remain unresolved because the relationship among the diverse rules of mitigation has not been systematically articulated.³

Recognizing that each party's mitigation responsibility is inextricably linked to the performance obligation of his contracting partner is the key step in fitting the mitigation principle into a general theory of contractual obligation.⁴ In recent years, a maturing theoretical scholarship has furthered understanding of the performance and remedial obligations of contracting parties.⁵ By focusing on

³ Several scholars have examined the duty to mitigate as part of a more general analysis of contractual performance and remedies. See Farnsworth, *supra* note 1, at 1183-99; Hillman, *Keeping the Deal Together After Material Breach—Common Law Mitigation Rules, The UCC, and the Restatement (Second) of Contracts*, 47 U. Colo. L. Rev. 553 (1976); Schmitthoff, *The Duty to Mitigate*, 1961 J. Bus. L. 361.

⁴ See *infra* text accompanying notes 14-17.

⁵ Recent theoretical scholarship on the behavior effects of contract rules has developed from two distinct and largely unrelated analytic traditions. The first tradition has evolved from the pioneering work on bargaining by Coase and others. See, e.g., Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960). These "bargain model" theorists have constructed models of contracting behavior under conditions of low transaction costs to examine the influence of different legal rules in environments where parties are able to allocate all relevant risks at the time of contracting. The major works in this tradition include Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. Legal Stud. 277 (1972); Jackson, "Anticipatory Repudiation" and the Temporal Element of Contract Law: An Economic Inquiry into Contract Damages in Cases of Prospective Nonperformance, 31 Stan. L. Rev. 69 (1978); Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. Legal Stud. 1 (1978); Priest, *Breach and Remedy for the Tender of Nonconforming Goods Under the Uniform Commercial Code: An Economic Approach*, 91 Harv. L. Rev. 960 (1978); Schwartz, *The Case for Specific Performance*, 89 Yale L.J. 271 (1979) [hereinafter cited as Schwartz, *Specific Performance*]; Schwartz, *Cure and Revocation for Quality Defects: The Utility of Bargain*, 16 B.C. Indus. & Com. L. Rev. 543 (1975) [hereinafter cited as Schwartz, *Cure*]; Shavell, *Damage Measures for Breach of Contract*, 11 Bell J. Econ. 466 (1980). Our own work with this analytic technique is Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 Yale L.J. 1261 (1980) [hereinafter cited as Goetz & Scott, *Enforcing Promises*]; Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 Colum. L. Rev. 554 (1977) [hereinafter cited as Goetz & Scott, *Liquidated Damages*]; Goetz & Scott, *Measuring Sellers' Damages: The Lost-Profits Puzzle*, 31 Stan. L. Rev. 323

particular performance problems, this scholarship has not only uncovered further questions but also heightened interest in a theoretical formulation that weaves the performance and remedial rules of contract into a single fabric.

Part I of this article develops an analytic model of optimal mitigation as a further step toward a general theory of contractual obligation. The model answers two questions: First, what general formulation of a mitigation principle best addresses the broad contractual goals of most parties? Second, what more specific rules are required to implement this mitigation principle? The mitigation principle derived from the model requires each bargainer to extend efforts to discover, share, and act on relevant information so as to minimize the *joint* costs of providing performance or its equivalent.

The major variable influencing the content of the specific rules that reduce the mitigation principle to actual practice is the market for substitute performances. Thus, in Part II, we first test the implications of our model in a transactional environment involving a well-developed market for substitute performances. In such environments, the standard categorical contract norms governing contract performance and mitigation provide appropriate rules for most bargainers. Indeed, the model clarifies a number of puzzles, including the uncertain relationship between perfect tender and cure,⁶ the reluctance to require injured parties to deal with

(1979) [hereinafter cited as Goetz & Scott, *Sellers' Damages*].

A parallel tradition has developed from theoretical models of industrial organization and other complex relationships. These "transaction costs" theorists have focused on methods of reducing transaction costs in complex contractual relationships. They assume that uncertainty and complexity often *prevent* parties from accurately allocating all relevant risks at the time of contracting. This scholarship thus examines the strategies parties devise to encourage subsequent cooperation in such relational contracts. Principal contributions to this literature include Goldberg, *Regulation and Administered Contracts*, 7 *Bell J. Econ.* 426 (1976); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976); Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law*, 72 *Nw. U.L. Rev.* 854 (1978); Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & Econ.* 233 (1979). Our effort in this tradition is Goetz & Scott, *Principles of Relational Contracts*, 67 *Va. L. Rev.* 1089 (1981) [hereinafter cited as Goetz & Scott, *Relational Contracts*].

⁶ See *infra* text accompanying notes 69-81.

breachers,⁷ and the requirement that a clear and unequivocal repudiation precede any maturing duty to mitigate.⁸

In Part III, we consider the contrasting transactional environment of specialized contracts. There are peculiar problems affecting specialized contracts, especially those within a relational environment, that require different and more flexible rules.⁹ Although a number of common-law rules, such as the doctrine of substantial performance, respond in part to these special problems, the existing rules remain deficient in two respects. First, standard mitigation rules do not motivate optimal reduction of losses because they are not sufficiently precise to fit particular situations. Second, the uncertain judicial treatment of provisions such as liquidated damages agreements and bonuses limits the contracting parties' ability to achieve unusual objectives through specially bargained arrangements.¹⁰

We argue that the traditional categorical rules of obligation and mitigation are inadequate for many classes of specialized contractors. Moreover, broad discretionary standards of behavior, such as a general duty to use best efforts to mitigate, present acute enforcement difficulties in relational contexts. Individual bargainers, therefore, should be granted wide latitude to devise customized mechanisms to achieve their complex contractual objectives. We suggest that the state might appropriately assist this process by formulating a more complete and clearly defined menu of preformulated contract clauses. Parties could then select alternative subsets of contractual rules to govern their specific situation, choosing those best suited to the particular environment. In sum, although the traditional general rules of contractual obligation

⁷ See *infra* text accompanying notes 55-60.

⁸ See *infra* text accompanying notes 61-68.

⁹ Contracts are relational

to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.

Goetz & Scott, *Relational Contracts*, *supra* note 5, at 1091.

¹⁰ The most significant cost of the common-law penalty doctrine results from its inducing the "review of the entire continuum of cases where liquidated damages provisions are intended to reimburse true losses which are to any extent uncertain." Goetz & Scott, *Liquidated Damages*, *supra* note 5, at 594.

work well in contractual relationships in which there is a good market for substitute performances, only more finely tuned norms can accommodate the growing complexity of specialized arrangements.

I. A MODEL OF OPTIMAL MITIGATION

Most contract rules are permissive, applying only if the parties do not otherwise agree. By providing standardized and widely suitable risk allocations in advance, the law enables most parties to select a preformulated legal norm "off-the-rack," thus eliminating the cost of negotiating every detail of the proposed arrangement.¹¹ Atypical parties remain free to bargain for customized provisions, much as a person with an unusual physique may purchase custom-tailored garments for a premium rather than accept a standard size and cut available at a lower price.¹²

Ideally, the preformulated rules supplied by the state should mimic the agreements contracting parties would reach were they costlessly to bargain out each detail of the transaction.¹³ Using this benchmark raises two separable issues: First, what arrangements would *most* bargainers prefer? And, second, what atypical arrangements should be supported as benign alternatives?

The model developed in this article will show that the contractual obligee and obligor would agree in advance to minimize the joint costs of adjusting to prospective contingencies, assigning the responsibility of mitigating to whoever is better able to adjust to the changed conditions. The occurrence of contingencies requiring

¹¹ Contracting parties reduce costs by allocating particular risks to whichever one of them has the comparative advantage in risk-bearing. Typically, each promisor bears the risk of his own nonperformance because, between a promisor and promisee, the promisor is better placed to reduce this risk. A promisor not only knows the factors affecting the cost of his own performance, but he can also raise his level of precaution to reduce the risks affecting performance. See Goetz & Scott, *Liquidated Damages*, supra note 5, at 579-83.

¹² Because the distinction between these two types of rules is so germane to much of our discussion, we will classify them respectively as "preformulated" and "particularized" rules.

¹³ Assigning the dominant role in supplying preformulated contract rules to the state assumes that the state has some advantage over private parties. We defer any detailed discussion of the theoretical and factual bases for this assumption to a subsequent article. See Goetz & Scott, *A Supply Analysis of Private Law Rule Making* (forthcoming 1983). Even if we concede that the state has a comparative advantage in rule-making, however, the state should incur the costs of supplying appropriate rules only if the benefits of contract-making exceed its harms. See Goetz & Scott, *Enforcing Promises*, supra note 5.

adjustment, however, may encourage strategic behavior by both parties: the obligor may attempt to evade his performance responsibilities while the obligee may bargain opportunistically whenever his cooperation is requested. Any effort legally to regulate one manifestation of this strategic behavior almost inevitably exacerbates the other. But where a developed market for substitute performances exists, the potential for opportunism is negligible; parties can therefore focus on eliminating evasion of contractual obligations without losing the benefits of cooperation. The tension between performance and mitigation responsibilities is most keen in situations lacking a good substitute market; parties in such environments must balance the costs of evasion and opportunism, knowing that no single solution will eliminate the tension.

A. *The Principle of Joint-Cost Minimization*

1. *The Readjustment Contingency*

Formulating the ideal mitigation principle requires one first to identify the kinds of costs contracting parties might want to reduce. The parties recognize many of the costs of promissory activity at the time of contracting and allocate these within the scope of the defined contractual rights and obligations. For instance, they may condition alternative modes of performance or excuse from performance upon the occurrence of certain contingencies. It is one thing, however, to perceive a risk in a manner sufficient to allocate its consequences to one party or the other; it is quite another to work out definitively the optimal responses to all future contingencies.¹⁴ As time passes and information increases, parties reassess the risk associated with certain future contingencies. Such reassessments may follow a change in the probability of an event, the magnitude of its consequences, or both. Inevitably, the party who perceives an increase in prospective cost will regret the initial assignment of risks.

A regretting promisor will react to such a "readjustment contingency"¹⁵ by selecting the least costly of the following alternatives:

¹⁴ See *infra* text accompanying notes 134-46.

¹⁵ The readjustment contingency is simply a more refined form of what we have previously called the "regret contingency": the future occurrence of an event or condition that would motivate the promisor to breach the contract if breach were costless. Such an occurrence implies that either the promisor or promisee must bear a cost. See Goetz & Scott,

(1) he may continue to pursue the original performance obligation and absorb whatever loss results from his higher performance costs; (2) he may breach and pay compensatory damages; or (3) he may attempt, by renegotiation or otherwise, to modify the original contract. Although a regretting promisor will naturally seek the least costly alternative, *interparty* cooperation is frequently essential to *minimize* adjustment costs.¹⁶ In other words, both parties may have to adjust in order to exploit fully the net benefits of contracting.

Once a contract has been made, an obligee may seem to have little interest in the obligor's excess costs. But a party who anticipates bearing excess costs will presumably negotiate for a more costly return promise to compensate for those inflated costs. Because the terms acceptable to a risk-bearing obligor will reflect the expected magnitude of his potential regret costs, both parties gain if they agree in advance to provisions that will reduce expected future costs.¹⁷ One can therefore derive a broad principle of mitigation by predicting how contractors would agree to cooperate if charged explicitly with designing a policy to cope with readjustment contingencies. The resulting mitigation principle would require each contractor to extend whatever efforts in sharing information and undertaking subsequent adaptations that are necessary to minimize the *joint* costs of all readjustment contingencies.

2. *The Doctrine of Avoidable Consequences and Its Related Rules*

The doctrine of avoidable consequences confirms this cost-minimizing conception of the mitigation principle, requiring a mitigator to bear the risk of his failure to minimize losses. It denies a mitigator recovery for losses he unreasonably failed to avoid, but allows him full recovery for costs incurred through any reasonable affirmative efforts to minimize losses.¹⁸ The courts seem implicitly to

Enforcing Promises, *supra* note 5, at 1273. The term "readjustment contingency" recognizes that mutual cooperation can reduce the expected losses associated with some regret contingencies.

¹⁶ See *infra* text accompanying notes 29-40.

¹⁷ See Jensen & Meckling, *supra* note 5.

¹⁸ The doctrine of avoidable consequences has both negative and affirmative aspects. The affirmative branch of the doctrine permits recovery of all reasonable expenses that plaintiff incurs in seeking to avoid damages. See, e.g., *Rench v. Hayes Equip. Mfg. Co.*, 134 Kan. 865,

have adopted a joint-cost minimization construction of "reasonable."¹⁹ In one illustrative case, breaching subcontractors argued that the plaintiff prime contractor should have mitigated damages by withdrawing from a building contract and forfeiting the one percent bid bond.²⁰ The court rejected their claim, reasoning that "[t]he duty of the plaintiff to keep the damages as low as reasonably possible does not require of it that it disregard its own interests [in maintaining good will] or exalt above them those of the defaulting defendants."²¹ In other words, although the doctrine of avoidable consequences requires a mitigator to minimize the joint

8 P.2d 346 (1932); *Morrison v. Queen City Elec. Light & Power Co.*, 193 Mich. 604, 160 N.W. 434 (1916). Although the expenditures must be reasonable, the outlay itself establishes a prima facie case. See, e.g., *Hoehne Ditch Co. v. John Flood Ditch Co.*, 76 Colo. 500, 233 P. 167 (1925). Reasonable efforts include securing a substitute for a failed performance. See, e.g., *Elias v. Wright*, 276 F. 908 (2d Cir. 1921); *Gilliland v. Hawkins*, 216 Ala. 97, 112 So. 454 (1927); Restatement (Second) of Contracts § 350(2) (1979); U.C.C. §§ 2-704(2), 2-708, 2-710, 2-712, 2-715 (1978).

The negative branch of the doctrine precludes a plaintiff from passively incurring losses which he could reasonably avoid or from actively increasing such losses where prudence would require an adjustment. See *C. McCormick*, supra note 1, at 127-30. For example, a plaintiff may not continue to perform services under a contract once the other party repudiates. See, e.g., *Rockingham County v. Luten Bridge Co.*, 35 F.2d 301 (4th Cir. 1929); *Craig v. Higgins*, 31 Wyo. 166, 224 P. 668 (1924); Restatement (Second) of Contracts § 350(1) comment b, illustrations 1-5 (1979). In one frequently cited case, an employer wrongfully discharged an employee after learning of an outstanding judgment against him and disbelieving his claims of payment. The court denied the employee damages because he had failed to show his employer proof of payment, a measure that might have reduced or avoided the loss. *Penna v. Atlantic Macaroni Co.*, 174 A.D. 436, 161 N.Y.S. 191 (1916). Courts frequently apply this "inaction" branch of the doctrine to require substitute performance. See, e.g., Restatement (Second) of Contracts § 350 comment c, illustrations 5, 7 (1979); U.C.C. §§ 2-708(1), 2-713(1), 2-715(2)(a) (1978).

¹⁹ *C. McCormick*, supra note 1, at 130-36. Common-law courts have developed several rules of thumb to implement this reasonableness standard. First, they evaluate the available mitigation strategies from the plaintiff's perspective at the time of breach and do not penalize him if he selected a reasonable strategy that proved retrospectively to be inferior. See U.C.C. § 2-704(2) comment 2 (1978) (mitigator not penalized "unless . . . the facts as they appear at the time he learns of the breach [make] it clear that such action will result in a material increase in damages") (emphasis added). Second, they apply an "equal advantage" rule: a mitigator has no mitigation responsibility if the obligor could adjust as easily as the mitigator could. See, e.g., *S.J. Groves & Sons Co. v. Warner Co.*, 576 F.2d 524 (3d Cir. 1978) (subcontractor not required to mitigate by contracting for substitute where supplier was in as good a position to seek a supplemental supply as subcontractor).

²⁰ *Frederick Raff Co. v. Murphy*, 110 Conn. 234, 147 A. 709 (1929).

²¹ *Id.* at 243, 147 A. at 712. See also *Eastern Sportswear Co. v. S. Augstein & Co.*, 141 Conn. 420, 106 A.2d 476 (1954) (buyer's interest in selling quality clothing is justification for refusing to accept and repair defective goods); *Boten v. Brecklein*, 452 S.W.2d 86 (Mo. 1970) (no duty to enter into a partnership with hostile party).

costs of breach, it does not require minimizing the defendant's loss in a way that imposes a still greater loss on the mitigator himself.²²

A number of related rules nevertheless appear to diverge from the joint-cost minimization principle.²³ For example, a breacher can raise the failure to mitigate doctrine only as a defense to reduce his damages liability and not as an affirmative claim to protect his contract rights.²⁴ Furthermore, courts have refused to require potential mitigators to make cost-minimizing readjustments prior to an unequivocal breach of the contract.²⁵ Similarly, they have tolerated cost-increasing refusals to deal with the contract breacher²⁶ or refusals to make greater expenditures than the con-

²² Joint minimization of costs generally requires that a mitigator credit the breacher with any new profits he obtains by virtue of the breach. See, e.g., *McAleer v. McNally Pittsburg Mfg. Co.*, 329 F.2d 273 (3d Cir. 1964) (wrongfully discharged employee is chargeable with income he obtains from substitute employment); *Bertholf v. Fisk*, 182 Iowa 1308, 166 N.W. 713 (1918) (rule applies even though new employment is of a different kind); *Cole v. City of Houston*, 442 S.W.2d 445 (Tex. Civ. App. 1969) (same). Where a plaintiff can establish a "lost volume" claim, however, the additional profits by resale or reemployment do not replace the breached contract because the transaction would have occurred even without the breach. Thus, the mitigator need not credit the breacher with any such profits. For example, in one case a distributor began successfully competing with his franchisor following the franchisor's breach. The court rejected the franchisor's claim that the mitigation principle required the distributor to offset his damages by the newly gained profits, reasoning that the franchisor failed to prove the distributor could not have made the same profits even without the contract breach. *Sandler v. Lawn-A-Mat Chem. & Equip. Corp.*, 141 N.J. Super. 437, 358 A.2d 805 (App. Div. 1976). The validity of a "lost volume" claim depends entirely on assumptions about the transactions plaintiff could profitably have undertaken had the contract been performed and is doubtful whenever an available market exists for the seller's goods or services. See *Goetz & Scott, Seller's Damages*, supra note 5, at 348-54.

²³ See *infra* text accompanying notes 45, 50, 53, 55-59, 61, 69.

²⁴ See *supra* note 1.

²⁵ A plaintiff needs to extend efforts to avoid injurious consequences only when the advantage of adjustment is almost certain. He is not required to risk increases in uncompensated losses or experience the insecurity created by uncertainty. See, e.g., *Halliburton Oil Well Cementing Co. v. Millican*, 171 F.2d 426 (5th Cir. 1948); *Standard Growers' Exch. v. Hooks*, 22 F.2d 599 (5th Cir. 1927). See also *infra* note 27.

Common-law courts have so extended the rule that the mitigation duty matures only at the time of breach that no duty accrues at the time of anticipatory repudiation. See, e.g., *Continental Grain Co. v. Simpson Feed Co.*, 102 F. Supp. 354 (E.D. Ark. 1951), modified, 199 F.2d 284 (8th Cir. 1952) (affirmed timing of damages). See also *infra* text accompanying notes 61-66.

²⁶ See, e.g., *United States v. Sabin Metal Corp.*, 151 F. Supp. 683 (S.D.N.Y. 1957) (plaintiff seller entitled to recover difference between contract price and resale price despite refusal to accept defendant's offer to settle for amount greater than what plaintiff procured on resale after breach), *aff'd*, 253 F.2d 956 (2d Cir. 1958); *Canadian Indus. Alcohol Co. v. Dimbar Molasses Co.*, 258 N.Y. 194, 179 N.E. 383 (1932) (buyer not required to accept substitute offer from breaching sellers for molasses of different grade or price); *Minneapolis Threshing*

tract contemplates.²⁷ Can one explain these apparent departures from the mitigation principle? The next section addresses this question by suggesting how most contracting parties—if required to develop rules to govern agreements—might choose norms and exceptions that best reduce the theoretical mitigation principle to actual practice.

B. The Joint-Cost Minimization Principle in Actual Practice

1. Ideal Readjustment Responsibilities in a World of Perfect Adjudication

Assume that two parties, Seller and Buyer, enter into an executory contract in which Seller agrees to supply for \$250,000 an industrial air conditioning compressor for an office building that Buyer is constructing. Assume further that no preformulated contract rules apply except as the contracting parties specifically agree. The state merely offers standard norms of performance—perfect tender, substantial performance, etc.—and various remedial options as a menu of terms from which contracting parties must make individual selections. In this environment, contractors themselves *choose* the legal rules that will regulate their prospective relationship and the legal system will enforce whatever agreement is reached. Because this model is designed to predict the rules *most* bargainers would select, assume also that neither Seller nor Buyer has any unusual preference for risk or strategic behavior. Finally, to understand the task confronting parties who attempt to create an ideal system of contractual obligations, as-

Mach. Co. v. McDonald, 10 N.D. 408, 87 N.W. 993 (1901) (seller not required to take goods on terms offering less security for payment, even though price is higher than alternatives). See also *infra* text accompanying notes 98-104.

²⁷ Courts often state this rule in stronger terms: a plaintiff is not required to incur unusual or disproportionate expense in attempting to avoid damages. See, e.g., Illinois Cent. R.R. v. Cobb, Christy & Co., 64 Ill. 128 (1872) (plaintiff buyer not required to invest more money in buying other corn to perform resale contract where carrier's delay prevented its performance); *Haukland v. Muirhead*, 233 Mich. 390, 399, 206 N.W. 549, 552 (1925) ("[I]t was not the duty of plaintiffs to hazard the payment of money upon such uncertainties in an attempt to minimize a loss to them . . ."); Restatement (Second) of Contracts § 350(1) comment g (1979). See *supra* text accompanying notes 21-22. On the other hand, where a plaintiff can reduce a large loss by expending a small amount of money but fails to do so, he may not recover the resulting damages. See, e.g., *Sargent v. North End Water Co.*, 190 Cal. 512, 213 P. 33 (1923).

sume initially that both Seller and Buyer can instantly and costlessly enforce the rules of behavior.

Under such conditions, Buyer and Seller could easily separate the *liability* implied by risk-bearing from the *conduct* required for least-cost adjustment. For example, suppose that shortly after the parties conclude their contract a labor strike against the principal manufacturer causes the price of industrial compressors to rise to \$300,000. Seller, bound by the contract to supply a compressor for \$250,000, now faces a possible loss of \$50,000. Although the contractual obligation requires Seller to bear the cost of a price increase, it does nothing to encourage behavioral adjustments that minimize Seller's loss. Nonetheless, in a perfect adjudication environment, the parties could assign the adjustment responsibilities after the performance obligations were allocated. Whichever party could better adapt to the readjustment contingency would accept the obligation to do so, although the resultant expense would still be chargeable to the primary bearer of the risk in question. For example, if Buyer can adjust to the price increase at a lower cost than Seller—perhaps by purchasing substitutes, amending specifications, or taking some other action—Seller obviously would prefer to pay Buyer to adjust rather than bear his own higher costs.

2. *The Problem of Evasion in Defining Contractual Obligations*

In the real world of costly and time-consuming adjudication, however, neither the performance nor the readjustment responsibilities can be established and enforced except through imperfect rules that reflect a compromise among conflicting concerns. Moreover, the parties to an executory contract are compensated in advance in the form of premiums and discounts²⁸ to bear any future costs that may arise. Tensions result when conditions such as the price of compressors change unexpectedly, giving the adversely affected party a strong incentive to chisel on his performance obligation by denying that the contract assigned the particular risk to him. He may chisel by contesting facts, exploiting arguably ambiguous terms, or refusing to provide full compensation upon breach. Such attempts to escape performance obligations, together with

²⁸ See, e.g., Posner, *The Ethical and Political Basis for the Efficiency Norm in Common Law Adjudication*, 8 Hofstra L. Rev. 487, 491-93 (1980).

the other party's efforts to counteract them, create what we shall call evasion costs.

Attempts to evade are, in essence, a method of coercively redefining the performance obligations—of imposing a “new” and more favorable contract on the nonbreacher. Even without legal rules to restrain evasion, however, this behavior is not necessarily costless to the evader. The injured party may retaliate or the evader may damage his commercial reputation. Although the motive to chisel on performance obligations is in principle always present, counterbalancing costs will usually restrain actual attempts to do so. Nevertheless, the same contingencies that trigger readjustments may increase the benefits of evasion above the costs.²⁹ Because extralegal sanctions will not always deter evasion sufficiently, parties will want to bind themselves to legally enforceable obligations.

Contracting parties could design an unambiguous, categorical assignment of performance responsibilities if reduction of evasion opportunities were the sole concern. An unconditional right of specific performance, for example, would place the full burden of any readjustment contingency, both as to cost and conduct, on the party whose performance was affected by the contingency. Such an arrangement would not only reduce evasion otherwise possible because of ambiguity, but also eliminate the risk that costly mitigation efforts might not be fully reimbursed. Despite its efficacy in reducing evasion, however, it is not clear that contractual parties would actually find such an arrangement advantageous. A contract that relies solely on readjustments by a single contractor will generate substantial costs if the parties lack incentives to readjust cooperatively to subsequent events. To determine the most suitable legal rules, the parties must therefore balance reduction of evasion against the potential costs of relying solely on “autonomous” readjustments.³⁰

3. *The Costs of Autonomous Readjustments*

Autonomous readjustments by the obligor will fail to minimize

²⁹ See Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615, 618-25 (1981); Macaulay, *Non-contractual Relations in Business: A Preliminary Study*, 28 Am. Soc. Rev. 55 (1963).

³⁰ “Autonomous” readjustments comprise any actions that are within the sole control of a single contractor.

joint costs because the obligee has inadequate incentives to cooperate in reducing costs. The problem of noncooperation has two components: First, it distorts the obligor's choice among the three readjustment options; and, second, it deprives the obligor of information concerning the parties' relative abilities to adjust.

a. The Effects of Noncooperation on the Readjustment Choice

In analyzing the choice among the three avenues of readjustment previously identified—performance at higher cost, contract breach, and contract modification³¹—one should bear in mind that the first two options are theoretically equivalent ways to “satisfy” the contract. Indeed, breach together with payment of fully compensatory damages is properly regarded as alternative performance or “quasi-performance.”³² To determine how a regretting obligor might choose between performance and quasi-performance, assume in our model that Seller has the necessary information to recognize the intervening contingency (the labor strike) and to assess his available options. Once he recognizes the conditions likely to produce a price increase, he can always make cost-minimizing adjustments himself. For example, Seller can safeguard his supply of materials needed for performance by taking early delivery of a conforming compressor or by securing options to buy from alternative sources. Such an autonomous readjustment would preserve the option of fulfilling the original performance obligation regardless of any increased costs.

There may be circumstances, however, in which the obligee can more advantageously make all or part of the adjustment. For example, Buyer may be able to install adjustable windows, use temporary air conditioning units, or even delay occupancy until the strike is settled. Seller would be foolish under such circumstances to adjust autonomously; that would not be the cheapest way to satisfy his performance obligation.³³ Seller would instead prefer that

³¹ See *supra* text accompanying notes 15-16.

³² We will specifically indicate when we wish to distinguish nonsatisfactory breach (breach accompanied by insufficient compensatory damages) from satisfactory breach (sufficient damages). When we refer to breach without supplying a distinguishing adjective, we mean satisfactory breach.

³³ Although the obligor is likely to have the advantage in readjustments that minimize the cost of his own performance, it is equally plausible that the obligee will have the advantage in planning his own affairs so that the consequences of *non*performance are appropriately

Buyer readjust, even though Seller will have to bear the resulting expense. One can characterize an obligor's decision to breach, therefore, as an election to surrender *irrevocably* his option to perform³⁴—a request that the obligee bear *all* future adjustment costs, with damages provided as reimbursement. Breach is the obligor's signal that: "My assessment of our relative capacities suggests that you enjoy the comparative advantage on all prospective adjustments. Therefore, please undertake all cost-minimizing adjustments and send me the bill." In essence, breach involves a final commitment to quasi-performance (breach with damages) as the most efficient means of satisfying the original contractual obligation.

Although an obligee cannot prevent an obligor from electing to breach, the choice of breach itself is not really a fully autonomous adjustment because the obligee frequently exercises considerable control over the way in which quasi-performance is effectuated. For example, the obligee controls the acquisition of "cover," the use of substitutes, and the timing of reactions. Absent mitigation rules, an obligee's indifference to making cost-effective adaptations may powerfully affect the *cost* of the breach option. This is a classic case of "moral hazard": the party whose rights are "insured" by the performance obligation is unwilling to adopt precautions that benefit the insurer.

Even if the probability of breach is quite low, as long as the decision to perform or breach is still under consideration, the non-breacher retains considerable influence over the costs of autonomous readjustment. An obligor is always interested in satisfying his contractual obligation as cheaply as possible; he has no a priori preference for performance or for quasi-performance. Because an obligor may closely weigh the relative advantage of each of his options during the period before the obligation matures, a non-breacher can distort an obligor's choice among all three readjustment alternatives³⁵ by increasing the expected cost of quasi-performance. In short, because the nonbreacher lacks incentives to

minimized. Hence, if autonomous readjustments were the exclusive means of reacting to contingencies, the costs of satisfying contracts would in many cases be inflated.

³⁴ Breach may be a rather blunt method of readjustment; not only does the breacher irrevocably abandon performance as a means of contractual satisfaction, he also loses the obligee's return performance. See *infra* p. 983.

³⁵ See *supra* text accompanying notes 15-16.

cooperate in minimizing losses, autonomous readjustments by an obligor will generate excessive costs.

b. The Effects of Asymmetric Information on Autonomous Readjustment

If an obligor does not have sufficient information to recognize and evaluate the possibilities for readjustment, the distortion is even worse. His misinformation will cause him to over or underestimate the costs of quasi-performance and "invest" inefficiently in conduct affecting the relative probabilities of performance or breach. If Seller underevaluates the consequences of breach, and hence his compensatory damages liability, he will underinvest in "safeguard" behavior that would otherwise increase the likelihood of successful performance. An informational error in the opposite direction will result, of course, in an overinvestment in safeguard behavior and an inefficient reluctance to accept a risk of breach.

Requiring an obligee to convey information to the obligor will reduce the potential distortion of the obligor's adjustment choices. Optimal adjustment may also require an obligor to convey information to the obligee. Even if an obligee is perfectly willing to adopt mitigating adjustments, he may not be able to assess the available options without such crucial information as the obligor's estimated probability of nonperformance. Little can be done to remedy "invincible ignorance," a situation in which no one has access to the information necessary to recognize a cost-effective adjustment. But when one party does have access to information necessary for the other's cost-effective adjustment, the communication of that information should be ensured.

The problem of encouraging parties to share information is really just a special case of the problem of noncooperation just discussed:³⁶ because an obligee has no interest *ex post* in reducing obligor's costs, he has little incentive to convey helpful information. An obligee's failure to communicate information to the obligor is especially wasteful because it prevents the obligor from exploiting even those adjustments that, if perceived, would be under the obligor's autonomous control. In our hypothetical case, Buyer might be satisfied by a second-hand, refurbished compressor and Seller

³⁶ See *supra* p. 980.

might be able to supply one cheaply. But Seller loses this efficient readjustment opportunity if Buyer fails to disclose the acceptability of the substitute performance.

3. *The Problem of Opportunism in Renegotiation*

Parties are not limited to autonomous readjustments. If mutual cooperation is necessary to minimize costs, such cooperation can be achieved consensually through the third option of *renegotiation*.³⁷ By renegotiation, the parties can reallocate the rights and duties which have become inefficient because of intervening events. For example, Buyer could agree to delay his occupancy until the strike is settled. Seller would thus solicit Buyer's cooperation in making adjustments Seller could not achieve alone. The maximum payment Seller will offer Buyer is the difference between Seller's position with and without Buyer's cooperation.

Renegotiation, however, creates a moral hazard in addition to the obligee's indifference: the obligee may actually threaten to exacerbate damages unless the obligor purchases his cooperation at a premium. For instance, Buyer might engage in opportunistic behavior to extract the full "value" of his cooperation in adjusting to the strike.³⁸ He could accomplish this goal by foot-dragging, by inflating the estimates of mitigation costs, or by manifesting any other sign of reluctance to cooperate. Of course, Seller has analogous motives to induce Buyer's cooperation at minimum cost, perhaps by exploiting the potential for evasion as an implicit or explicit threat.

Would strategic behavior affect renegotiations more than original negotiations? Although both situations involve carving up gains from trade, renegotiations will provoke more costly strategies if parties have become "contractually specialized" and face substantially restricted alternate arrangements. At best, renegotiations impose significant transaction costs on the parties. Especially when opportunism magnifies them, renegotiation costs tend to impede

³⁷ See *supra* text accompanying notes 15-16.

³⁸ Williamson defines opportunism as "self-interest seeking with guile." See Williamson, *supra* note 5, at 234 n.3. Such strategic behavior includes "huffs, threats, and games of 'chicken' designed to exploit another party's presumed bargaining disadvantage." Goetz & Scott, *Relational Contracts*, *supra* note 5, at 1101 n.26. See also Muris, *Opportunistic Behavior and the Law of Contracts*, 65 *Minn. L. Rev.* 521 (1981).

readjustments that offer potential benefits for both parties. Parties will hesitate to trade information necessary for readjustments if bargaining over such transfers may itself alert the potential buyer to all or part of the very information that one might wish to "sell." Moreover, even when the parties ultimately achieve cooperative readjustment, the associated renegotiation costs remain a dead-weight loss reducing the potential benefits of the contractual relationship.

4. The Tension Between Performance Obligations and a Duty to Mitigate

Contracting parties could reduce renegotiation costs by agreeing in advance to a detailed set of alternative rights and duties conditioned upon varying future circumstances. Attempts to provide built-in readjustment within the terms of the original obligation, however, confront a number of serious problems. Increasing the complexity of the obligational definition not only facilitates evasion, but also exposes a party to what we shall call the "breacher-status" problem of contract law. A party who contests the interpretation of his obligation by withholding any part of the disputed performance risks being characterized as a breacher. Obviously, the status of breacher is disadvantageous because the breacher is liable for compensatory damages. Frequently overlooked, however, is the breacher's loss of an accrued interest in what may be extremely valuable return rights.

For instance, if our Seller withholds performance based on a plausible claim of excuse due to the labor-caused price increases, he still risks being assigned breacher status by a court. Unlike a deliberate choice of breach, however, this classification does not imply that the consequences of breach were superior to those of performance. Indeed, a court-labeled breacher will frequently view his course of action in retrospect as a serious error. Moreover, a court will assign the burden of interpretation errors exclusively to the first party making a mistake; there is only one breacher and he frequently loses the entire benefit of his bargain.

The breacher-status problem gives parties an additional incentive to select clear, definitive rules of obligation to safeguard the initial allocation of contractual rights. Clear rules of obligation, however, are potentially incompatible with a sufficiently adaptive

set of mitigation responsibilities.³⁹ The parties can reduce both error costs (from insufficient readjustment) and renegotiation costs only by prescribing a more detailed statement of shared responsibilities. Unfortunately, that advantage necessarily accrues at the cost of increased difficulty in enforcing original obligations.⁴⁰

5. *The Influence of a Market for Substitute Performances*

The existence of a market for substitute performance permits parties to reduce the tension between clear performance standards and mitigation responsibilities. Where markets for numerous and close substitute performances exist, the advantages of clear, categorical rules of performance tend to dominate the advantages of elaborate readjustment responsibilities. Such markets eliminate much of the need for mitigation rules because the parties can often make optimal adjustments autonomously by, in essence, purchasing them from the lowest bidder in the marketplace.

In our illustrative case, assume that Seller and Buyer are equally capable of covering by purchasing a substitute compressor on the spot market at the contract price plus the \$50,000 premium added by the strike. The market offers both parties the opportunity to readjust autonomously, fixing the cost of doing so at \$50,000. Because Seller's access to substitute performance serves as a realistic and effective limit on excessively costly readjustment and renegotiation, the parties can focus on minimizing the difficulties of defining and enforcing the original obligation rather than on mitigation.

Where a specialized market provides fewer substitutes, the strategies for cost-minimization become more varied. As the market for substitute performances thins, the opportunity cost of an alternative performance increases for both parties and the bargaining range is correspondingly expanded. In such an environment, an obligor becomes more vulnerable to an obligee's refusal to readjust.⁴¹ For example, if Seller's additional performance costs amount to \$80,000, Buyer may demand a \$75,000 premium to readjust even

³⁹ See *supra* text accompanying notes 29-30.

⁴⁰ See *id.*

⁴¹ A well-developed market would reduce both uncertainty and a mitigator's opportunistic behavior by providing an objective measurement of the costs of alternative performances. As the market for substitute performances thins, however, the difference between a mitigator's adjustment costs and the obligor's autonomous adjustment alternatives expands.

though he may be able to place himself in an equivalent position for \$50,000. Buyer, on the other hand, can "sell" his mitigation advantage only to Seller, who may resist paying any premium. The absence of accurate information on the objective "value" of Buyer's readjustment capacity exacerbates this mutual dependence. Both the dependence and informational factors tend to spur opportunism as market accessibility diminishes.⁴²

In this more complex environment, therefore, parties must balance the potential evasion and opportunism costs in structuring obligation and mitigation rules. One approach to balancing these costs is to establish a general standard of obligation and mitigation responsibilities such as a "best efforts" or a fiduciary obligation. Ideally, such an inclusive norm will reduce substantially the opportunities for strategic behavior, thus counterbalancing the increased difficulty of determining liability under a general standard of responsibility. Another approach is to design narrower "rules of thumb" which require mitigation in predetermined circumstances. The doctrine of substantial performance in construction contracts, for example, requires the nonbreacher to mitigate by accepting a deficient performance coupled with money damages. Rules of thumb preserve some of the clarity of a market-influenced rule structure, yet they soften the impact of the conventional breacher-nonbreacher distinction.⁴³ No single solution, however, will fully resolve the dilemma of conflicting performance and mitigation

⁴² See Klein, Crawford & Alchian, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J.L. & Econ. 297, 298-302 (1978). Strategic moves also produce inefficient overinvestments in counterprecautions. *Id.* See also Goetz & Scott, Relational Contracts, *supra* note 5, at 1100-1101 & 1101 n.25 (discussing responses to strategic behavior and noting that investment will be determined by the parties' perceptions of their next best opportunity).

⁴³ Although a party tendering a substantial but deficient performance has breached his contract, he does not lose all his accrued contractual rights. Instead, the injured party must mitigate by accepting a species of quasi-performance—substantial performance plus a monetary allowance—and supply the breacher his return performance. See *infra* text accompanying notes 114-17. By defining narrowly both performance and mitigation responsibilities, however, the substantial performance rule may not be suitable for all contractors. Nevertheless, as a *rule of thumb* it warns atypical parties to bargain explicitly for customized arrangements of risk and responsibilities to protect fully their contractual expectations. For example, atypical parties may agree to a bonus payment arrangement in which the mitigator pays a premium to exempt himself from a readjustment duty. Alternatively, a liquidated damages or penalty clause might require an obligor to pay the mitigator a premium as additional "insurance" against nonperformance.

goals. More specialized transacting environments simply require more varied and complex strategies to encourage optimal contractual behavior than do market environments.

II. MITIGATION IN THE COMPETITIVE MARKET

Many of the categorical rules governing contractual obligations seem incompatible with the broad principle of mitigation embodied in the doctrine of avoidable consequences.⁴⁴ Our model, however, suggests that, in a market with many and close substitute performances, most parties might indeed prefer clear, categorical rules of obligation together with only narrowly drawn mitigation responsibilities. Part II thus examines whether the categorical common-law rules can be explained and rationalized as manifestations of this rulemaking strategy.

A. *The Objective Compensation Principle*

The objective compensation principle limits damages from breach to the "amount of money that can be obtained in exchange for [the promised performance] in some market."⁴⁵ For example, assume that a highly developed market exists for air conditioning compressors conforming to the specifications in the contract between our hypothetical Buyer and Seller. Although labor unrest results in an increase of the spot price by \$50,000, either party can purchase a conforming compressor at that premium. The \$50,000 objective market value will limit Buyer's damages unless he has revealed any unusual circumstances or idiosyncratic preferences at the time of contracting. Even where standard exchange values are concededly inadequate, the objective compensation principle excludes any "fanciful" or unusual losses on the grounds that such losses are either speculative or unforeseeable.⁴⁶ Limitations on damage recovery encourage the parties to share information about contingencies that would potentially exacerbate the consequences of a breach.⁴⁷ In turn, they permit an obligor to value correctly the activities which increase the probability of his performance.

⁴⁴ See *supra* text accompanying notes 18-27.

⁴⁵ 5 A. Corbin, *Corbin on Contracts* § 1022 (1964).

⁴⁶ See Goetz & Scott, *Liquidated Damages*, *supra* note 5, at 573 n.53.

⁴⁷ This limitation on damages has two components. The first is the consequential damages rule of *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (1854). Denying damages for

The most striking aspect of the objective compensation principle is its temporal limitation: each party's responsibility for the consequences of breach embraces only those needs and circumstances known at the time of contracting.⁴⁸ For example, an obligor may discover just prior to performance that breach will cause previously unforeseeable losses to the obligee. Yet an obligor will suffer no legal sanction if he fails to warn the unsuspecting obligee to renegotiate for protection against the originally unforeseen losses.

Refusing to recognize any responsibility to share subsequently acquired information seems inconsistent with the mitigation principle. In the competitive market, however, the parties will tend to share all relevant information even without a legally imposed mitigation responsibility. Because the contract performance is readily

the unascertainable consequences of breach induces an obligee to disclose information that the obligor may not have possessed concerning future circumstances. Such a rule is consistent with a cost-minimizing strategy because unusual circumstances otherwise cause the obligee to misperceive the value of activities that enhance the probability of performance.

In addition to unforeseeable consequences, the objective damages rule also limits the recovery of idiosyncratic values. Thus the rule serves as a signal to the atypical or idiosyncratic bargainer who values the performance intrinsically more than the market to communicate these specialized concerns at the time of contracting. Once again, the cost-minimizing criterion justifies the limiting rule. Most bargainers, not having idiosyncratic preferences, would not be willing to purchase the extra "insurance" to protect special value. The idiosyncratic bargainer is thus encouraged to negotiate in advance for any additional performance insurance at the time of contracting.

⁴⁸ U.C.C. § 2-715(2)(a) (1978) ("Consequential damages resulting from the seller's breach include (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know . . .") (emphasis added). The *Hadley v. Baxendale* time of contracting limitation is justified by an obligor's need to calculate allocated risks ex ante in evaluating terms and attractiveness of the contract. Without such a rule, the injured party has an incentive to withhold disclosure of the unusual consequences of nonperformance until after the contract price is negotiated. Knowledge of special circumstances raises the price obligor demands to bear the added risk.

Courts may, however, sometimes hold the obligor responsible for subsequently learned consequences. See, e.g., *Virginia-Carolina Peanut Co. v. Atlantic Coast Line R.R.*, 155 N.C. 121, 71 S.E. 71 (1911) (carrier liable for delay-caused damages, even though unaware at time of contracting of need for prompt delivery, because he was so warned before delay occurred); *Conn v. Texas & N.O. Ry.*, 14 S.W.2d 1004 (Tex. App. Comm'n) (carrier liable for damages for negligent failure to deliver feed after special circumstances communicated while collecting freight charges), aff'd, 14 S.W.2d 1006 (Tex. 1929); *Bourland v. Choctaw, O. & G. Ry.*, 99 Tex. 407, 90 S.W. 483 (1906) (notice of urgency of prompt delivery of feed given at time of arrival sufficient to hold carrier for consequential losses to cattle following delayed delivery).

Although the *Hadley* rule is suitable for contractors who either know or can ascertain information necessary to reduce risks at the time of contracting, it becomes less so in relational or other specialized contexts characterized by uncertainty and complexity.

marketable by either party, there is no motivation for strategic renegotiation; the parties will "sell" discovered information at market value. In sum, where the market removes the threat of opportunism, renegotiation is an acceptable response to any readjustment contingency.

It is tempting to argue that, if such limited mitigation responsibilities are desirable in a market environment, then the remedy of specific performance should be preferred over objectively valued damages. An unqualified right to specific performance, after all, appears to offer special advantages in reducing the risk of evasion. It is precisely in this limiting case of close market substitutes, however, that the standard compensatory damages are as effective in restraining evasion and guaranteeing satisfaction of the original obligation as specific performance. Specific performance provides no additional security against a nonsatisfactory breach. The distinction between the two remedies therefore reduces to whether the obligee receives performance from his original obligor or acquires a perfectly fungible performance on the market with the obligor's damage payment. The distinction between specific performance and damages is only relevant when market alternatives do not provide good substitutes for original performance.⁴⁹

⁴⁹ See Kronman, *Specific Performance*, 45 U. Chi. L. Rev. 351 (1978); Schwartz, *Specific Performance*, *supra* note 5. Kronman defends the common-law limitations on specific performance by arguing that parties would not agree *ex ante* to a specific performance remedy where substitute performances are ordinarily available. In such markets, obligors would retain the choice of breach with damages in order to accept better offers, while obligees would be satisfied with money damages. If specific performance were routinely awarded in such markets, he concludes, parties would engage in costly renegotiations to buy out of the specific remedy. Kronman, *supra*, at 265-69.

Schwartz, on the other hand, demonstrates that the conventional objections to specific performance as a general remedy prove invalid in competitive markets. In such markets, parties can anticipate fluctuations in future prices which are reflected in the ruling market price. Thus, contracting parties would be less concerned *ex ante* about specific performance in competitive markets than in specialized markets where specific performance is generally available. Schwartz also argues that a buy-out of a specific performance remedy never actually requires costly renegotiations. Any seller preferring alternative uses of resources can adjust autonomously in a competitive market by acquiring a substitute and tendering the contract performance. Because the presumed inefficiencies of the remedy are nonexistent, and because it fosters full compensation for breach, he concludes that specific performance should routinely be available as a preformulated rule. Schwartz, *Specific Performance*, *supra* note 5, at 274-78, 279-91.

Although we agree with Schwartz that specific performance does not impose excess renegotiation costs when available in a market environment, our analysis suggests that, in a well-developed market for substitutes, specific performance has no peculiar benefits either. A

B. Anticipatory Breach and Avoidable Consequences

1. Conduct Constituting a Repudiation: The Problem of Pre-Breach Mitigation

Common-law courts have consistently held that a plaintiff need not take steps to avoid losses so long as the defendant has not clearly and definitively repudiated the contract.⁵⁰ Imagine, for example, that the hypothetical air conditioning contract was negotiated on April 1 with a delivery date of September 15. On May 1, Seller telegraphed Buyer stating: "In trouble on April 1 contract owing to unanticipated difficulties in acquiring necessary compressor. Don't see how we could deliver without price adjustment." The market price on May 1 was \$10,000 over the contract price. On August 1, after the market price had risen another \$20,000, Buyer telephoned Seller for clarification. Seller then replied, "We haven't attempted to secure a compressor nor do we plan to." Buyer shortly thereafter sued Seller for \$30,000 in damages based on the difference between the contract price and the August 1 market price. Seller now contests the damages claim, arguing that the anticipated performance difficulties were promptly communicated on May 1 and that a properly mitigating buyer would have undertaken precautionary adjustments at that time. Because Seller's equivocal actions would not constitute breach under the common law, however, his telegram on May 1 did not trigger any

categorical compensatory damages rule is as readily enforceable and presents no greater risks of measurement inaccuracies because market values can be easily established. As the market thins, however, the choice between specific performance and breach with damages become more important. Specific performance effectively restrains evasion (efforts to exploit ambiguity as well as to effect nonsatisfactory breach), but correspondingly increases renegotiation costs because of the mitigator's strategic advantage. See *infra* text accompanying notes 89-97.

⁵⁰ See, e.g., *Watts v. Camors*, 115 U.S. 353 (1885) (not necessary to find a new charterer of vessel as long as renegotiations are continuing); *Southern Nat'l Bank v. TRI Fin. Corp.*, 317 F. Supp. 1173, 1185 (S.D. Tex. 1970) ("Defendant had neither breached nor indicated an intention so to do; having not yet been injured by any breach of defendant's, plaintiff had no damages to mitigate."), *aff'd in part and vacated in part on other grounds*, 458 F.2d 688 (5th Cir. 1972); *Sunset Shingle Co. v. Northwest Elec. & Water Works*, 118 Wash. 416, 203 P. 978 (1922) (not necessary for plaintiff to seek substitute following defendant's failure to furnish electric power as agreed so long as defendant did not definitively repudiate the contract). Courts continue to apply the common-law rule that repudiation must be clear and unequivocal, and repudiation under the UCC similarly requires either a reasonable indication of rejection of the continuing obligation or an action rendering performance impossible. U.C.C. § 2-610 comments 1-2 (1978).

mitigation responsibility. Buyer can continue to rely completely on Seller's promise, as though the significant new information had not arisen.⁵¹

Although optimal mitigation would seem to require Buyer to adjust to the newly perceived circumstances, the existence of a competitive market largely explains why Buyer does not have to mitigate. Access to a market of substitute transactions enables Seller to readjust autonomously by purchasing conforming goods—perhaps on May 1—and then supplying them to Buyer when due. Because Buyer's relative advantage in mitigating will usually be modest in a market environment, a clear repudiation rule limits the breacher's ability to evade, but has little or no negative impact on the efficiency of readjustment itself. Most parties would presumably prefer such a rule to one that is more sensitive but also more difficult to apply.

In short, an injured party's mitigation responsibility matures only upon receipt of a clear signal of breach, thus preventing a breaching obligor from contending that the injured party should have adjusted earlier. Requiring a clear, unequivocal repudiation also reduces the risk of inadvertent breaches resulting from disputed interpretations of the performance obligations.

2. *Nonsatisfactory Breach and Insecurity*

Notwithstanding its benefits, the common-law requirement of clear and unequivocal evidence of repudiation does increase the loss exposure from nonsatisfactory breaches.⁵² In particular, the risk of incurring breacher status discourages a party from taking precautions to guard against potential undercompensation in the event of breach. For example, suppose that an obligor anticipated breach and, concerned about payment, suspended his own performance as "security" against possible nonpayment. If he guessed incorrectly, the suspension would itself constitute a breach of contract.

⁵¹ Restatement of Contracts § 336(1) comment a (1932) ("In general, however, it is reasonable for the plaintiff to rely upon the defendant to perform as he has promised."). Note, however, that the parallel comment of the Second Restatement does not repeat this language. Restatement (Second) of Contracts § 350 comment b (1979) (once party has reason to know performance will not be forthcoming, he is ordinarily expected to stop his own performance to avoid further expense).

⁵² See *supra* note 32 and accompanying text.

The insecure party's dilemma is best understood by viewing breach as a request for a loan equal to the amount of the ultimate damage bill as well as for mitigating readjustments. The amount of this potential loan is difficult to calculate at the time of contracting because the risks of nonpayment, as well as the costs of credit, are not known until the obligor actually requests readjustment. Although the parties are free to specify prejudgment interest in most jurisdictions, the appropriate credit rate, including risk premium, cannot be determined accurately until the circumstances of the loan are known.

Addressing the problem of nonsatisfactory breach, section 2-609 of the Uniform Commercial Code⁵³ authorizes the insecure party to demand assurances of "performance" once the need for readjustment arises, thus clarifying the obligor's ambiguous behavior. The assurance demand asks, "Are you going to breach or not? And what are the credit risks I must bear if you do?"⁵⁴

Because the drafters attempted to accommodate diverse market conditions within a general standard, however, section 2-609 invites evasion of the initial performance obligation. For example, while the insecure party presses for adequate assurances, he must worry about whether a court will find the assurances he seeks consistent with optimal mitigation. The very generality of section 2-609 invites evasive renegotiation of the contract as the price for

⁵³ U.C.C. § 2-609(1) (1978) provides in relevant part: "When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return."

⁵⁴ Three questions remain in applying the broad standards of § 2-609: What are "reasonable grounds for insecurity"? What are "adequate assurances of performance"? And when can the buyer safely suspend his own performance? Viewing breach as an extension of credit to the breacher clarifies these questions. The occurrence of a contingency requiring either party to adjust establishes reasonable grounds for insecurity. See, e.g., U.C.C. § 2-609 comment 3 (1978) (reasonable grounds for insecurity include situations where buyer "falls behind" in his account or seller makes "defective" deliveries to other buyers). An obligor can adequately assure the obligee that he will perform by establishing either that no readjustment contingency has occurred or, if it has occurred, that the terms and price of the credit meets current commercial standards. See, e.g., *id.* § 2-609 comment 4 (adequate assurance includes "posting of a guaranty" or good credit report). A buyer's suspension of performance is reasonable only if consistent with an efficient mitigation strategy. This situation parallels an insolvent debtor's choice between liquidation or reorganization. If the going-concern value of the contract (discounted by the expected costs of a nonsatisfactory breach) exceeds its liquidation value, efficient mitigation requires a buyer to maintain the contract.

"adequate assurances." Alternatively, the mitigation model suggests the advisability in a competitive market of a precise laundry list of conditions creating insecurity. A clear and highly inclusive insecurity rule would reduce evasion by the obligor while the market would restrain the obligee's opportunistic use of the rule's overbreadth.

3. *The Duty to Deal with the Breacher*

Most courts have declined to impose any duty on a mitigator to deal with the breacher, even where the breacher offers the best re-adjustment option. For example, suppose that several weeks after the August 1 repudiation, Seller offered to deliver a conforming compressor if Buyer agreed to pay the price in cash with an interest discount instead of the sixty-day credit provided by contract.⁵⁵ Seller has in effect entered the salvage market and bid for the cover contract. If Seller were a *third party* presenting the lowest bid, optimal mitigation would require Buyer to accept the best cover option or risk losing the ability to recover the entire damage bill from Seller.⁵⁶ A court would not require Buyer to accept Seller's offer of cash with a discount, however, even if it were superior to all other alternatives and even if it did not require Buyer to relinquish any claims arising from the breach.⁵⁷ Similarly, courts

⁵⁵ Suppose that Seller instead offered to comply fully with the contract by the September delivery date. Would Buyer have to deal with him then? Unless Buyer has cancelled the contract or otherwise changed his position, the Code grants Seller the right to retract the repudiation and reinstitute the contract even though Buyer would be legitimately insecure about the possible nonsatisfactory breach. U.C.C. § 2-611 (1978).

⁵⁶ The doctrine of avoidable consequences acts as a restraint on the damage bill eventually submitted by the mitigator. See *supra* text accompanying notes 18-19.

⁵⁷ Obviously, the mitigator would not have to accept the modified offer if it required him to abandon his rights under the original contract. See, e.g., *Stanspec Corp. v. Jelco, Inc.*, 464 F.2d 1184 (10th Cir. 1972); *Campfield v. Sauer*, 189 F. 576 (6th Cir. 1911).

Even if the modified offer preserved prior rights, however, "it is not necessary for the plaintiff to make another contract with the defendant who has repudiated, even though he offers terms that would result in avoiding loss." 5 A. Corbin, *supra* note 45, § 1043 (footnote omitted). See also, e.g., *Everett v. Emmons Coal Mining Co.*, 289 F. 686 (6th Cir. 1923) (nonbreaching buyer has no duty to mitigate by providing bond rather than by paying on credit); *Coppola v. Marden, Orth & Hastings Co.*, 282 Ill. 281, 118 N.E. 499 (1917) (no duty to pay in cash when credit terms are material part of contract); *Louis Cook Mfg. Co. v. Randall*, 62 Iowa 244, 17 N.W. 507 (1883) (same); *Theis v. duPont, Glore Forgan, Inc.*, 212 Kan. 301, 510 P.2d 1212 (1973) (where one broker in commodity trading firm had traded in disregard of principal's orders, principal had no duty to deal with another broker from same firm even though that might reduce damages); *Cain v. Grosshans & Petersen, Inc.*, 196 Kan.

have permitted buyers to reject offers to purchase the contract goods at higher prices⁵⁸ or at different shipping points.⁵⁹

Again, the presence of a competitive market explains this limitation on Buyer's mitigation responsibility. In such an environment, parties will choose clear rules to restrain evasion by a disappointed obligor. Any party's comparative advantage in providing a readjustment superior to the market is slight; in our hypothetical, Seller can borrow on the market as easily as Buyer.⁶⁰ Thus, the no-duty-to-deal rule reinforces an obligor's categorical performance responsibility, discouraging evasion, without substantially increasing the costs of readjustment.

4. Post-Breach Mitigation: Time of Repudiation v. Time of Performance

Upon anticipatory repudiation, the common law permits an obligee either to seek damages at the time of repudiation or to wait until time for performance and recover damages based upon the market differential at that later date.⁶¹ Assume, in our hypothetical, that following the August 1 repudiation Buyer took no further action until the September 15 time for performance. During the six-week period, the market price of a contract compressor increased again from \$280,000 to just over \$300,000. Despite Buyer's failure to respond earlier in a steeply rising market, he would be entitled to the full difference between the \$250,000 contract price and the \$300,000 market price at the time of performance.⁶²

497, 502, 413 P.2d 98, 102 (1966) ("[A]n innocent party is not [automatically] required to execute a less advantageous contract with one who has already welsed on his agreement."); *Frohlich v. Independent Glass Co.*, 144 Mich. 278, 107 N.W. 889 (1906) (buyer's failure to pay old indebtedness does not absolve seller of later contract breach nor does it force buyer to pay cash to mitigate); *Coxe Bros. v. Anoka Waterworks, Elec. Light & Power Co.*, 87 Minn. 56, 91 N.W. 265 (1902) (buyer not required to pay cash in lieu of credit even though seller offered discount which would make requested cash payment equivalent to original credit offer).

⁵⁸ See, e.g., *Campfield v. Sauer*, 189 F. 576 (6th Cir. 1911); *Canadian Indus. Alcohol Co. v. Dunbar Molasses Co.*, 258 N.Y. 194, 179 N.E. 383 (1932).

⁵⁹ See, e.g., *Pope Metals Co. v. Sadek*, 149 Wis. 394, 135 N.W. 851 (1912).

⁶⁰ Courts have expressed this notion through what we have termed the "equal advantage" rule. See *Bjork v. April Indus., Inc.*, 547 P.2d 219 (Utah 1976), cert. denied, 431 U.S. 930 (1977). See also *supra* note 19.

⁶¹ See, e.g., *Reliance Cooperage Corp. v. Treat*, 195 F.2d 977 (8th Cir. 1952); *Missouri Furnace Co. v. Cochran*, 8 F. 463 (C.C.W.D. Pa. 1881).

⁶² See U.C.C. §§ 2-610(a); 2-713(1) (1978). See generally 5 A. Corbin, *supra* note 45, §

This common-law rule appears inconsistent with the joint-cost minimization principle embodied in the doctrine of avoidable consequences.⁶³ Free choice is efficient only so long as the decisionmaker internalizes all relevant costs and benefits. The non-breacher, however, does not "see" an external cost that should be relevant in deciding how and when to readjust. Here, if the market declines, Buyer would retain all of the benefits from waiting while, if the market rises, Seller must bear all the costs. Without a legal rule to encourage him, Buyer lacks incentives to make the efficient decision. Indeed, Buyer's incentive is always to wait until the time for performance in order to speculate at Seller's expense.⁶⁴ Moreover, the Code's reformulation of the common-law anticipatory repudiation rule, allowing an obligee to await performance for a "commercially reasonable time,"⁶⁵ also seems inadequate to encourage optimal mitigation because it too allows Buyer to speculate.⁶⁶

The goal of any rulemaking strategy, however, includes minimiz-

1042 (stating responses to anticipatory repudiation under common law and noting that responding party need not risk money or reputation); C. McCormick, *supra* note 1, at 665-67 (noting that the remedy for nondelivery is the difference between contract price and market price at time of performance); Jackson, *supra* note 5, at 75, 76 & n.24, 77-78 (1978) (citing cases).

⁶³ See *Mays Mills, Inc. v. McRae*, 187 N.C. 707, 122 S.E. 762 (1924); *Cron & Dehn, Inc. v. Chelan Packing Co.*, 158 Wash. 167, 290 P. 999 (1930); 2 S. Williston, *The Law Governing Sales of Goods at Common Law and under the Uniform Sales Act* §§ 587-88 (2d ed. 1924) [hereinafter cited as *S. Williston, Sales*]; Jackson, *supra* note 5, at 86-94.

⁶⁴ See Jackson, *supra* note 5, at 93-94.

⁶⁵ U.C.C. § 2-610(a) (1978). Following an anticipatory repudiation, the aggrieved party may await performance for a "commercially reasonable" time. Buyer can then choose either to cover under § 2-712 or to recover the difference between the contract and the market price under § 2-713. In either case, the key question is whether the market price at the time of repudiation or the price at the time for performance should be used in computing damages. A statutory analysis of the relevant Code provisions fails to answer this question because the Code's language can support either the time of performance or the time of repudiation as the relevant base period. See A. Schwartz & R. Scott, *Commercial Transactions: Principles and Policies* 319-20 (1982). Courts deciding such cases under the Code are divided. Compare *Oloffson v. Coomer*, 11 Ill. App. 3d 918, 296 N.E.2d 871 (1973) (time of repudiation) with *Cargill, Inc. v. Stafford*, 553 F.2d 1222 (10th Cir. 1977) (time for performance presumptively reasonable unless evidence suggests earlier opportunity to purchase substitute goods is readily available). See also Restatement (Second) of Contracts § 350 comment f (1979) (mirroring the Code's concern with advancing the time at which the mitigation duty accrues).

⁶⁶ Jackson, *supra* note 5, at 100-01. But see A. Schwartz & R. Scott, *supra* note 65, at 323-25 (arguing that a time of repudiation rule implicitly—and unrealistically—assumes fully compensatory damages will be awarded).

ing the evasion problems produced by an ambiguous obligation rule as well as reducing readjustment costs. In this case, the trade-off is clear. The common-law time-of-performance rule encourages an obligee to extort a side payment from the obligor in exchange for his agreement to cover promptly in a rising market. On the other hand, to require mitigation at the time of repudiation would enhance the potency of any threats of evasive acts.⁶⁷ Thus, the common-law time-of-performance rule is also an implicit security against evasion, particularly the threat of nonsatisfactory breach.⁶⁸ The rule is an weak security device, however, because it fails to reduce substantially the nonbreacher's risk of undercompensation. If the obligor waits until the time for performance and then announces breach, his ability to threaten inadequate or delayed payment of the damage bill remains unchecked.

The net effect of requiring a more timely cover remains indeterminate. In our example, Buyer could cover on the spot market shortly after repudiation, but, if the market for substitute performance is ample, Buyer's comparative advantage in covering is only marginally better than Seller's ability prior to repudiation. Increases in the evasive behavior of the disgruntled Seller would arguably consume these marginal gains. The most that can be said of the common-law repudiation rule is that it is not plainly inferior to any other preformulated rule.

C. Tender, Rejection, and Cure

1. The Perfect Tender Rule

Under the common-law perfect tender rule, an obligee has no duty to accept defective performance or offers to remedy the defect following a tender of nonconforming goods.⁶⁹ Assume, for example, that Seller tenders a compressor in due course on the 15th of September. On examination, Buyer discovers that the aluminum casing used is Type B rather than Type A as specified in the contract. Seller concedes that Type B casing is a slightly lighter alloy

⁶⁷ Some common-law cases implicitly recognize this argument. See, e.g., *Saxe v. Penokee Lumber Co.*, 159 N.Y. 371, 54 N.E. 14 (1899). See also 2 S. Williston, *Sales*, supra note 63.

⁶⁸ See A. Schwartz & R. Scott, supra note 65, at 325.

⁶⁹ See U.C.C. § 2-601 (1978); Uniform Sales Act § 69(1) (1906); 1 S. Williston, *Sales*, supra note 63, § 225; Honnold, *Buyer's Right of Rejection: A Study in the Impact of Codification Upon a Commercial Problem*, 97 U. Pa. L. Rev. 457 (1949).

and costs \$3,000 less than the contract-specified variety. Furthermore, although the lighter casing will increase the risk of heat dispersion to some extent, an insurance policy can be purchased for \$2,500 to guard against this contingency. Nonetheless, Buyer decides to reject the "nonconforming" tender. Seller then offers Buyer \$3,000 if he retracts his rejection and accepts the compressor with the Type B casing. Must Buyer accept Seller's offer? The common-law perfect tender rule offers Buyer a choice: accept the deficient performance and recover the reduction in value as damages or reject the defective tender and recover the difference between the contract price and the market price at the time of tender.⁷⁰

The discretion offered by the perfect tender rule is not inconsistent with the mitigation principle. Even without legal compulsion, Buyer would have incentives to elect the cheapest readjustment option to reduce his exposure as a creditor seeking reimbursement of the damage bill. Buyer may also earn goodwill and a reputation as an efficient mitigator that will be reflected in the terms of subsequent transactions. Only a counterbalancing opportunity for opportunistic gains, therefore, would divert Buyer from the appropriate course, and such gains are unlikely to present themselves in a developed market. For example, the cost of potential adjustments or a corresponding unwillingness to accept a compensatory payment in place of rejection can be easily tested by the market. If Buyer's refusal is idiosyncratic or strategic, Seller simply offers the compressor elsewhere at a competitive price. The existence of many and close substitute performances reduces not only the bargaining range within which strategic claims can be made, but also the uncertainty that encourages them. Furthermore, Seller has an incentive to reveal the cost of his various adjustment options because ultimately he bears these costs anyway.

Suppose, however, that a "double lightning bolt" causes both Seller and Buyer to experience regret. This could happen, for example, if the market price for a conforming compressor *declined*, but a temporary shortage increased the cost of Type A aluminum casing. Seller would have an incentive, in such a situation, to sub-

⁷⁰ Although both the British and American Sales Acts incorporated the perfect tender rule, common-law courts have developed some flexibility in its application. See, e.g., *LeRoy Dyal Co. v. Allen*, 161 F.2d 152, 155 (4th Cir. 1947); Honnold, *supra* note 69, at 460-62.

stitute the less costly Type B casing to protect his expected profits. Buyer, on the other hand, would now prefer to escape the contract—by rejecting Seller's tender as "nonconforming"—and purchase a compressor at the lower market price.⁷¹ However uncommon this result might be, the drafters of the Code, and Professor Llewellyn in particular, feared that in such a case the common-law perfect tender rule would not yield optimal results. During the years in which the Code was in draft form, Llewellyn and other scholars expressed concern about the phenomenon of "surprise rejections" and the imposition of unnecessary costs on the breaching party.⁷² Although they framed the argument in terms of "economic waste"—wastefully forcing a seller to take goods back—they feared strategic moves by the buyer to exploit a minor defalcation for his own purposes.

2. *The Right of Cure*

Section 2-508(2), the result of this concern, permits a seller to "cure" a defective tender.⁷³ If our Seller reasonably believed that Buyer would find a compressor with a lighter casing acceptable with or without a money allowance, then section 2-508(2) grants Seller an additional period of time to substitute a "conforming" tender.⁷⁴ Determining when such a right of cure should be available, however, presents a problem. The conventional surprise rejection illustration suggests that, if a seller were under an obligation to tender 1,000 widgets and tendered only 999, rejection by the buyer would trigger the right of cure under section 2-508(2).⁷⁵ One

⁷¹ See Schwartz, *Cure*, *supra* note 5, at 556-59 (arguing that conditions necessary to produce buyer bad faith are unlikely to occur in markets where prices rarely undergo dramatic fluctuations).

⁷² See Honnold, *supra* note 69, at 469-70; Llewellyn, *On Warranty of Quality, and Society*: II, 37 *Colum. L. Rev.* 341, 389 (1937).

⁷³ Section 2-508(2) affords a seller time beyond tender to cure the defect "[w]here the buyer rejects a non-conforming tender which the seller had reasonable grounds to believe would be acceptable with or without money allowance."

The categorical right to return defective goods is further qualified by § 2-608 (acceptance can be revoked only if the nonconformity substantially impairs quality), § 2-504 (defective contract of carriage is basis for rejection only if material loss or delay results), and § 2-612 (any nonconforming installment can be rejected, but only where nonconformity substantially impairs value of the installment).

⁷⁴ See *supra* note 73.

⁷⁵ Comment 2 of § 2-106 reads in part:

It is in general intended to continue the policy of requiring exact performance by the

cannot reconcile this analysis, however, with the Code's definition of "conforming" goods. If the parties reasonably believed such a tender would be acceptable because of prior dealings or prevailing usage of trade, then the contract would incorporate this contextual understanding within the section 2-106 definition of "conforming goods."⁷⁶ The surprise rejection illustration typically used as an example of section 2-508(2) thus merely illustrates a seller's legitimate surprise at the rejection of *conforming* goods. Such a rejection would be wrongful *ab initio* and never require the application of section 2-508.⁷⁷

Circumstances in which goods require adjustment before they are in good working order⁷⁸ also provide inappropriate illustrations of section 2-508(2). If adjustment is regarded as incidental to the tender of such goods, then the need to adjust does not render the goods nonconforming. A buyer's attempted rejection would again be wrongful.

To invoke section 2-508(2) properly, one must imagine a case in which the tender is clearly defective, but the seller nonetheless anticipates that the buyer will accept the tender as a legitimate readjustment option. These requirements are satisfied where one can evaluate the deficiency on the market and correct it with a mone-

seller of his obligations as a condition to his right to require acceptance. However, the seller is in part safeguarded against surprise as a result of sudden technicality on the buyer's part by the provisions of section 2-508

U.C.C. § 2-106 comment 2 (1978). See also J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code 321 (2d ed. 1980) ("Thus, presumably, in absence of special circumstances, when the seller delivers goods which are not identical to those called for in the contract but which are the functional equivalent, he has reasonable cause to believe they will be acceptable."); Honnold, *supra* note 69, at 474 (discussing the then new option of cure proposed by Revised Sales Act).

⁷⁶ See U.C.C. § 2-106(2) (1978) (defining goods as conforming if "they are in accordance with the obligations under the contract"); *id.* § 1-201(11) (defining "contract" as the "total legal obligation which results from the parties' agreement"); *id.* § 1-201(3) (defining "agreement" as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this Act").

⁷⁷ See A. Schwartz & R. Scott, *supra* note 65, at 265-66. The drafters of the Code are largely responsible for the misleading conventional interpretation of § 2-508(2). For example, comment 2 provides that the "reasonable grounds [to believe a tender would be acceptable] can lie in prior course of dealing, course of performance or usage of trade." U.C.C. § 2-508 comment 2 (1978). In such a case, of course, the goods would be *conforming* and any rejection would be *wrongful* and thus not embraced within § 2-508.

⁷⁸ See, e.g., *Wilson v. Scampoli*, 228 A.2d 848 (D.C. 1967); *Bartus v. Riccardi*, 55 Misc. 2d 3, 284 N.Y.S.2d 222 (City Ct. 1967).

tary payment accompanying the tender. What surprises Seller in our hypothetical is not the rejection of his defective performance, but the rejection of the defective performance accompanied by the offer to send \$3,000—more than enough money to insure against the consequences of the defect.

Granting a seller the right to cure under appropriate conditions serves two functions. First, section 2-508(2) encourages a buyer anticipating special losses from nonperformance to bargain for additional protection at the time of contracting. If a buyer attaches an idiosyncratic valuation to the seller's performance, the inadequacy of ordinary methods of cure necessitates such augmented protection. Even without section 2-508(2), however, the objective damages principle would encourage the early communication of idiosyncratic values. Second, and perhaps more importantly, the cure provision restrains opportunistic claims by Buyer. Unfortunately, it also invites evasion by Seller through the tender of inadequate substitutes as a "cure."

Even in a competitive market situation, however, a right of cure may be necessary to restrain an obligee's opportunistic behavior. Despite the initial existence of a market at the time of contracting, the double lightning bolt transforms the contract into a specialized relationship with few and imperfect substitutes. This species of bilateral monopoly raises legitimate fears of costly renegotiation following the defective tender.⁷⁹ The doctrine of avoidable consequences, moreover, fails to restrain opportunism under these conditions. Although an obligee will be unable to recover avoidable costs and any expenses saved if he strategically rejects the obligor's tender, the exclusively defensive character of the rule fails to protect accrued contract rights that optimal mitigation could have preserved.⁸⁰ Seller has valuable return rights in the favorable price shift, but possesses no effective remedy other than renegotiation if Buyer elects to reject the inadequately housed compressor and merely walks away from a now disfavored deal.

In short, once circumstances eliminate close substitutes, categorical standards of performance may no longer reliably serve to reduce costs. The common-law perfect tender rule encourages the nonbreacher in a bilateral monopoly to demand a premium to ac-

⁷⁹ See Goetz & Scott, *Relational Contracts*, *supra* note 5, at 1101-02.

⁸⁰ See *supra* note 1 and text accompanying notes 24-27.

cept the retendered goods. Reducing readjustment costs under these circumstances requires a rule that reduces buyer opportunism by more than it increases seller evasion. The failure of the Code's cure provision thus lies in its ambiguity and generality. Only where the context clearly signals a need for more complex rules should the seller be empowered to demand the right of cure.⁸¹

D. Particularized Agreements: Liquidated Damages, Bonuses, and Express Conditions

When preformulated contract rules fail to fit circumstances, contracting parties would prefer more carefully tailored alternatives. Common-law courts have traditionally looked with skepticism, however, at the private arrangements designed by atypical contracting parties. Liquidated damages clauses, for example, are traditionally held unenforceable as penalties if they fail to mirror the objective compensation achievable under standard damage rules.⁸² Also, bonus agreements may be attacked as unlawful wagers if they attempt to protect risks and values that are not objectively quantifiable.⁸³ Finally, express conditions which permit suspension of an agreed performance if a particular condition is unsatisfied are carefully scrutinized with the injunction that the law abhors a forfeiture.⁸⁴

Specially designed contract provisions are useful in protecting accrued contract rights from exploitation.⁸⁵ Even in markets with close substitutes, particularized clauses are important for any atypical bargainer. The objective compensation principle fails to protect any nonmarket or nonpecuniary values that a bargainer may attach to performance. To the extent judicial scrutiny of liquidated damages and bonus arrangements prevents the protection of such

⁸¹ In writing about the need to ameliorate the harsh effects of the common-law rules in the "double lightning bolt" case, Llewellyn implicitly recognized the equal importance of a narrowly crafted solution. See Llewellyn, *supra* note 72, at 378, 389-90, 391 & n.130. See also Priest, *supra* note 5, at 968-75 (discussing Llewellyn's influence on the Code rules governing nonconformity tender).

⁸² See Goetz & Scott, *Liquidated Damages*, *supra* note 5, at 574-76.

⁸³ A wagering contract that creates risk is distinguished from a valid insurance contract which merely allocates existing risk to another party for a price. See R. Keeton, *Basic Text on Insurance Law 89-90* (1971). If the specialized value is not legally recognizable, then the bonus arrangement is virtually indistinguishable from a wager on the contract performance.

⁸⁴ See, e.g., *Restatement (Second) of Contracts* §§ 227-29 (1979).

⁸⁵ See *infra* text accompanying notes 128-31.

values except through expensive third-party insurance, atypical bargainers face increased costs of contracting.⁸⁶ Moreover, the right to challenge a particular damage or bonus provision exerts an in terrorem effect discouraging the use of specially negotiated incentive schemes.

The hypothesis that common-law rules of contractual obligation are implicitly premised on the competitive market model explains judicial hostility to such arrangements. The existence of a market checks opportunistic claims: specialized arrangements necessary to reduce strategic renegotiation are rarely required. In the market context, fairly negotiated penalty clauses would be rare because the market would circumscribe their usefulness. Indeed, only the idiosyncratic bargainer requires a special incentive system to protect his nonpecuniary values—an unusual case for which third-party insurance is an available, although more expensive, substitute.⁸⁷ Thus, penalty provisions found in market-regulated transactions frequently may signal unfairness in the bargaining process. Given the difficulty of verifying idiosyncratic values, a rule of thumb that incentive clauses protecting atypical values are indicative of fraud or duress⁸⁸ may well be justifiable.

But this defense of a strict scrutiny of specially tailored incentive arrangements ignores their crucial importance in coping with the peculiar problems of specialized contractors. When contracting takes place in a more complex, relational context, the full cost of such scrutiny becomes apparent.

III. THE PROBLEM OF SPECIALIZATION

A. *Specialized and Relational Contracts*

The extent of contractual specialization is the variable that most influences the mitigation strategies of contracting parties. An available market for substitute performances provides a powerful

⁸⁶ See Goetz & Scott, *Liquidated Damages*, supra note 5, at 578-83.

⁸⁷ See Rea, *Nonpecuniary Loss and Breach of Contract*, 11 *J. Legal Stud.* 35 (1982) (arguing that insuring idiosyncratic losses is frequently irrational and parties would rarely bargain to protect nonpecuniary values through liquidated damages). See also Clarkson, Miller & Muris, *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 *Wis. L. Rev.* 351. But see Poliusky, *Risk Sharing through Breach of Contract Remedies*, 12 *J. Legal Stud.* 427 (1983) (for risk averse parties, a liquidated damages clause is optimal method of allocating and sharing risks).

⁸⁸ See Goetz & Scott, *Liquidated Damages*, supra note 5, at 588-93.

explanation for the apparent incongruity between categorical rules of contractual obligation and the mitigation principle. By contrast, specialization implies that when midcourse readjustments are required, the market will not be available to deter strategic claims. Once the need for readjustment arises, a specialized context encourages parties to waste resources in strategic maneuvering.

Moreover, the problems caused by specialization can erupt even where the parties initially have perfectly substitutable trading partners. Whenever the original obligation imperfectly provides for future contingencies, a mutual dependency similar to that of a relational contract develops between the parties.⁸⁹ Contracts are relational to the extent that parties are unable to reduce *performance* obligations to definitive terms, either because of uncertain future conditions or the inherent difficulty of adequately characterizing certain complex situations.⁹⁰ An analogous problem exists in defining readjustment duties. Even where the parties can precisely define performance—i.e., the contract itself is not relational—readjustment contingencies may or may not be susceptible to advance planning. In relational contracts, it seems almost certain that the very difficulties which infect performance specification will present equally formidable obstacles in defining readjustment agreements. Hence, relational contracts present a “worst case” environment for contractual formulation.

Softening the categorical quality of the common-law rules offers one response to the problem of specialization. Through the doctrine of substantial performance and related provisions, common-law courts have crafted rules for certain classes of contracts incorporating both performance and readjustment responsibilities.⁹¹ These more responsive rules reduce a potential mitigator's incentive to demand a premium for his cooperation, but their additional complexity also increases the threat of evasion by a disgruntled obligor. An obligor may thus succeed in claiming that either an inadequate performance or an undercompensatory quasi-performance

⁸⁹ See Goetz & Scott, *Relational Contracts*, *supra* note 5, at 1100-03. Because specialization increases the difference between one readjustment strategy and the next best alternative, the bargaining range confronted during renegotiation correspondingly expands. Absent a competitive market, objective valuations of the performance will be difficult to ascertain.

⁹⁰ See *supra* note 9.

⁹¹ See *infra* text accompanying notes 114-17.

(breach with damages)⁹² satisfies his contractual obligation. Reducing the incidence of one type of behavior almost necessarily exacerbates the other.

The rules governing specific performance are typical of the more complex obligations routinely applied to specialized contractors. Specific performance serves as the preformulated remedy for specialized contracts involving sales of unique goods or land.⁹³ But an unconditional right to specific performance would increase opportunism and its associated renegotiation costs. Courts have therefore conditioned specific performance awards on a number of factors, including the obligee's "good faith"⁹⁴ and adequate security for the return performance.⁹⁵ For example, although the courts usually grant the cost of completing performance for a builder's breach of a construction contract, they will deny such recovery where the award greatly exceeds the "economic loss" caused by the breach.⁹⁶ Such a carefully conditioned right of specific performance not only restrains evasion but also selectively filters the potentially

⁹² See *supra* note 32 and accompanying text concerning "quasi-performance" and non-satisfactory breach.

⁹³ See, e.g., *Copylease Corp. of Am. v. Memorex Corp.*, 408 F. Supp. 758 (S.D.N.Y. 1976) (inability to cover on market justifies specific performance award); *Henderson v. Fisher*, 236 Cal. App. 2d 468, 46 Cal. Rptr. 173 (1965) (contract for land presumptively unique), *aff'd*, 260 Cal. App. 2d 218, 66 Cal. Rptr. 896 (1968); U.C.C. § 2-716(1) (1978) ("where the goods are unique or in other proper circumstances"). A form of specific performance—the cost of completion—is generally awarded for breach of construction contracts. See, e.g., *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921); *Di Bernardo v. Gunneson*, 65 A.D.2d 828, 409 N.Y.S.2d 838 (1978) (mem.); Restatement (Second) of Contracts § 362 (1979). Courts also award specific performance for breach of certain relational contracts where specialization increases the risks of evasion of performance. See, e.g., *Laclede Gas Co. v. Amoco Oil Co.*, 522 F.2d 33 (8th Cir. 1975); *Eastern Air Lines v. Gulf Oil Corp.*, 415 F. Supp. 429, 442-43 (S.D. Fla. 1975).

⁹⁴ See, e.g., *Public Water Supply Dist. v. Fowlkes*, 407 S.W.2d 642, 647 (Mo. Ct. App. 1966); Schwartz, *Specific Performance*, *supra* note 5, at 272-74.

⁹⁵ See, e.g., *Rego v. Decker*, 482 P.2d 834 (Alaska 1971); Restatement (Second) of Contracts § 377 (1979).

⁹⁶ An owner generally recovers the cost of completion unless this cost greatly exceeds the diminution in the market value of the property owing to the defect. See, e.g., *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921) (contractor need not replace all pipes in house when difference between pipe specified and that installed was small but cost of replacement would be high); *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109 (Okla. 1962) (refusing to award \$29,000 cost of completion where market value diminished by \$300), *cert. denied*, 375 U.S. 906 (1963); *W.G. Slugg Seed & Fertilizer, Inc. v. Paulsen Lumber, Inc.*, 62 Wis. 2d 220, 214 N.W.2d 413 (1974) (refusing to award \$15,000 cost of completion where diminution in value was only \$5,000).

opportunistic cases where the obligor's cost of performance is substantially greater than the market value of performance.⁹⁷

A casual review of various contractual rules thus reveals a noticeable sensitivity to the character of the market. At the same time, it also suggests that creating efficient, preformulated rules incorporating both performance and mitigation responsibilities is no simple matter.

B. Post-Breach Mitigation: The Duty to Deal with the Breacher

To what extent have courts successfully adapted market-environment mitigation rules to the context of more specialized transactions? The analysis in the next section concludes that, at least for certain classes of transactions, the common law has created appropriate rules of thumb that accommodate the specialized environment.

⁹⁷ In a specialized context, the value of performance to an obligee may well exceed any objective market calculation. Courts recognizing such a specialized value will thus award the cost of completion despite the difference between obligee's valuation and the market's. For example, one court stated:

If a proud householder, who plans to live out his days in the home of his dreams, orders a new roof of red barrel tile and the roofer instead installs a purple one, money damages for the reduced value of his house may not be enough to offset the strident offense to aesthetic sensibilities

Gory Associated Indus., Inc. v. Jupiter Roofing & Sheet Metal, Inc., 358 So. 2d 93, 95 (Fla. Dist. Ct. App. 1978). See also Farber, Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract, 66 Va. L. Rev. 1443, 1471-73 & nn.94-100 (1980) (citing cases); Harris, Ogus & Phillips, Contract Remedies and the Consumer Surplus, 95 Law Q. Rev. 581, 589-91 & nn.53-63 (1979) (citing English cases).

Where courts conclude that a plaintiff's insistence on the cost of completion represents an opportunistic bargaining position rather than a specialized value, however, they award only the diminution in value. See, e.g., Peevyhouse v. Garland Coal & Mining Co., 382 P.2d 109 (Okla. 1962), cert. denied, 375 U.S. 906 (1963); Wigsell v. Corporation of the School for the Indigent Blind, 8 Q.B.D. 357 (1882). But see Groves v. John Wunder Co., 205 Minn. 163, 286 N.W. 235 (1939) (cost of completion awarded where court inferred had faith evasion by obligor).

Although this more elaborate and complex damage rule demonstrates a sensitivity to the specialized environment, no preformulated rule of general application will successfully restrain both evasion and opportunism. See *infra* text accompanying notes 118-25 and 131-34 (arguing for judicial tolerance of individually tailored arrangements in specialized contexts, the development of situation-specific norms of limited application, or both); Speidel, Court-Imposed Price Adjustments Under Long-Term Supply Contracts, 76 Nw. U.L. Rev. 369, 411-22 (1981) (arguing for court-imposed adjustments under discretionary, non-rule-based intervention, but recognizing uncertainty costs such interventions might impose on subsequent bargainers).

1. *Avoidable Consequences*

Assume now that Seller assembles the industrial air conditioning compressors to Buyer's unique specifications so that at the time for performance there is no spot market for conforming compressors. Seller proposes to perform the contract for an additional payment of \$40,000 which, although wrongful, represents the best available opportunity. If Buyer fails to accept the offer, will the doctrine of avoidable consequences preclude his recovery of losses?

Unlike other mitigation problems, the duty-to-deal issue has been the subject of substantial litigation. In cases where the breach occurs in a market with close substitute performances, courts rarely penalize the injured party for failing to accept a substitute offer from the breacher.⁹⁸ As the market for substitute performance thins, however, the judicial decisions become increasingly less uniform. Not surprisingly, these decisions at first appear confused and contradictory. For example, courts have generally held that an obligee should accept a new offer on similar terms and should deal on modified or additional terms where no close substitute transaction is available.⁹⁹ On the other hand, they have not imposed a duty to deal if the new offer is "personally repugnant" or oner-

⁹⁸ See *supra* text accompanying notes 57-60.

⁹⁹ The extent of contractual specialization in employment contracts seems to explain why courts have been more willing to require the "injured" employee to accept a new offer from the contract breacher. See, e.g., *Dary v. The Caroline Miller*, 36 F. 507 (S.D. Ala. 1888) (seaman forfeited damages by refusing master's offer to reemploy for return voyage thereby saving losses); *Flickema v. Henry Kraker Co.*, 252 Mich. 406, 233 N.W. 362 (1930) (hotel manager's refusal to accept new offer by breacher admissible in mitigation); *Heiferman v. Greenhut Cloak Co.*, 143 N.Y.S. 411 (City Ct.) (designer's refusal to accept offer of reemployment barred recovery), *rev'd*, 83 Misc. 435, 145 N.Y.S. 142 (App. Term 1913), original order reinstated *mem.*, 163 A.D. 939, 148 N.Y.S. 1119 (1914).

Similarly, courts have consistently imposed a duty to deal with the breacher in disputes over specialized service contracts. See, e.g., *Henrici v. South Feather Land & Water Co.*, 177 Cal. 442, 170 P. 1135 (1918) (landowner required to pay additional charge for water services rather than permit crops to be lost); *Severini v. Sutter-Butte Canal Co.*, 59 Cal. App. 154, 210 P. 49 (1922) (defendant's refusal to pay irrigation fee in advance barred recovery for subsequent loss of crop); *Key v. Kingwood Oil Co.*, 110 Okla. 178, 236 P. 598 (1924) (jury should have been allowed to consider whether unreasonable to shut down drilling operation rather than accept offer to supply gas at \$5 more per day); *Eggert v. Kullmann*, 204 Wis. 60, 234 N.W. 349 (1931) (plaintiff's refusal to pay defendant contractor additional \$160 to impound house during construction bars recovery for subsequent collapse of structure).

ous,¹⁰⁰ involves inferior work,¹⁰¹ is distasteful,¹⁰² is made in bad faith,¹⁰³ or requires a waiver of damages for breach.¹⁰⁴

Because specialized contexts warrant more responsive mitigation duties, the law arguably ought to require a mitigator to deal with the breacher, even upon additional or inferior terms, whenever substitute transactions are clearly inferior to the breacher's offer. Indeed, the seemingly contradictory common-law decisions have consistently identified the absence of alternative performance as a major variable justifying an expanded duty to deal with the breacher.

The cases that apparently depart from such a duty-to-deal principle in the specialized context do so when either of two types of evasion costs plays a key role. Evidence of bad faith extortion is the first variable that influences duty-to-deal outcomes.¹⁰⁵ Specialized environments significantly increase the risk of threats, bluffs,

¹⁰⁰ See, e.g., *Price v. Davis*, 187 Mo. App. 1, 173 S.W. 64 (1915) (employee not required to return to job because parties had quarreled prior to wrongful discharge); *Connell v. Averill*, 8 A.D. 524, 40 N.Y.S. 855 (Sup. Ct. 1896) (head porter not required to work at more physically demanding job of house porter); *Levin v. Standard Fashion Co.*, 11 N.Y.S. 706 (Ct. C.P. 1890) (wrongfully discharged employee called a thief and otherwise insulted by defendant's agent); *Williams v. School Dist.*, 104 Wash. 659, 177 P. 635 (1919) (school principal not required to work as teacher under former subordinate).

¹⁰¹ See, e.g., *Parker v. Twentieth Century-Fox Film Corp.*, 3 Cal. 3d 176, 474 P.2d 689, 89 Cal. Rptr. 737 (1970) (plaintiff entitled to refuse "different and inferior" leading role in another motion picture in substitution of breached contract); *Clayton-Greene v. De Courville*, 36 T.L.R. 790 (K.B. Div'l Ct. 1920) (same).

¹⁰² See, e.g., *Horn v. Luntz*, 125 N.Y.S. 786 (App. Term 1910) (no obligation to accept reemployment following assault by employer); *Plesofsky v. Kaufman & Flonacker*, 140 Tenn. 208, 204 S.W. 204 (1918) (buyer not required to pay cash in lieu of agreed credit if "distasteful burden"); *Stanley Manly Boys' Clothes, Inc. v. Hickey*, 113 Tex. 482, 259 S.W. 160 (Tex. App. Comm'n) (buyer need not accept "humiliating" offer to deal on cash basis), aff'd, 259 S.W.2d 163 (Tex. 1924).

¹⁰³ See, e.g., *Schisler v. Perfection Milker Co.*, 193 Minn. 160, 258 N.W. 17 (1934) (dictum); *Southwestern Gas & Elec. Co. v. Stanley*, 45 S.W.2d 671 (Tex. Civ. App. 1931), aff'd, 123 Tex. 157, 70 S.W.2d 413 (1934) (avoidable consequences doctrine does not apply where defendant electric company made bad faith attempt to coerce payment of disputed bill in unrelated transaction by terminating service).

¹⁰⁴ See, e.g., *Stanspec Corp. v. Jelco, Inc.*, 464 F.2d 1184 (10th Cir. 1972) (seller of equipment not required to accept modified contract in mitigation when it includes abandonment of any right of action for prior breach as a condition of acceptance); *Everett v. Emmons Coal Mining Co.*, 289 F. 686 (6th Cir. 1923) (same); *Campfield v. Sauer*, 189 F. 576 (6th Cir. 1911) (same); *Cain v. Grosshans & Petersen, Inc.*, 196 Kan. 497, 413 P.2d 98 (1966) (same).

¹⁰⁵ Bad faith extortion is defined in this context as one party's attempt to coercively redefine contractual obligations to secure a larger slice of the "pie" than the contract originally allocated.

or other games of "chicken" designed merely to redistribute the existing contractual entitlements. Contracting parties considering this problem in advance would prefer rules that discourage bad faith claims,¹⁰⁶ perhaps by withdrawing the mitigation duty whenever the risk of such evasion is substantial. Reflecting this concern about extortion, courts have uniformly refused to impose a duty to deal when an offer requires the waiver of rights under the original

¹⁰⁶ Contract rules policing contractual modification are another response to the heightened risk of extortion in specialized environments. For example, the common-law preexisting duty rule can be usefully contrasted with the more permissive regulation of contractual modification under the Uniform Commercial Code. The preexisting duty rule denies enforcement of a renegotiation or contractual modification where an obligor agrees merely to do that which he is already contractually obligated to do. The rule is primarily designed to reduce the incidence of extortionate modification in construction, employment, and other specialized contractual relationships. See, e.g., *Alaska Packers' Ass'n v. Domenico*, 117 F. 99 (9th Cir. 1902) (refusing enforcement of a modified contract to pay fishermen increased compensation demanded once they reached work site in Alaska).

The preexisting duty rule, however, often fails accurately to mirror the underlying bad faith behavior. First, the rule discourages cost-reducing renegotiations in addition to threats. Moreover, the obligor satisfies the rule by assuming *any* additional obligations whether or not the "additional" duties are themselves part of the strategic maneuver. The Code abandoned this ill-fitting rule of thumb and instead applies a general good faith standard. See U.C.C. § 2-209(1) (1978). Because this standard is substantially more difficult to enforce, however, the Code may not deter extortionate renegotiation as effectively as did the common law. Nonetheless, if parties generally execute contracts for the sale of goods in the context of a well-developed market for substitutes, the costs saved through legitimate renegotiations will exceed the increased enforcement costs of policing bad faith modification.

Courts also express concern with bad faith extortion through the rules restraining economic duress. Such cases arise when the obligor has *performed* the modified contract, but the "injured party" seeks restitution of the value of his performance because economic duress forced his agreement to the modified terms. See, e.g., *Austin Instrument, Inc. v. Loral Corp.*, 29 N.Y.2d 124, 272 N.E.2d 533, 324 N.Y.S.2d 22 (1971). The market for substitutes is the key variable in economic duress cases. For example, "a mere threat by one party to breach the contract by not delivering the required items, though wrongful, does not in itself constitute economic duress. *It must also appear that the threatened party could not obtain the goods from another source of supply.*" *Id.* at 130-31, 272 N.E.2d at 534, 324 N.Y.S.2d at 25-26 (footnote omitted) (emphasis added). Because a market for substitutes will effectively control a defendant's behavior with no need for legal rules, a *prima facie* claim of economic duress thus requires a plaintiff to show a specialized environment.

It is difficult to police such bad faith behavior, however, because the distinction between legitimate requests for renegotiation and bad faith threats lies entirely in the honesty of a party's assertion that a readjustment contingency made *performance* less attractive than quasi-performance (breach with damages). When a professional athlete requests renegotiation because he now prefers lying in the sun (and paying appropriate compensation) to playing football or basketball, the issue turns on whether that claim is true or represents a bluff designed to obtain additional compensation. Because such a claim is almost impervious to accurate proof, the law must choose between no *legal* regulation and crudely devised rules of thumb.

contract, is "humiliating and degrading," or otherwise appears to be strategically motivated.¹⁰⁷

Courts have also declined to impose a duty to deal—even though the alternative performances impose greater costs—whenever there is a substantial risk that the breacher will undercompensate the injured party.¹⁰⁸ For example, courts have not imposed a duty to deal in construction contracts where the new offer requires a postponed performance on modified terms.¹⁰⁹ These cases seem puzzling unless one recalls that a tender of inadequate compensation (a nonsatisfactory breach) is a principal means of evading assigned performance obligations.¹¹⁰ Where readjustment requires an extensive "loan" without sufficient guarantee of payment, the mitigator must accept a credit contract which he would never negotiate separately on the market.

This rationale for refusing to impose a duty to deal also applies to cases involving personal service or aesthetic contracts where a reemployment offer is "different" or "inferior."¹¹¹ Even where insolvency is not a principal issue, significant undercompensation can result if there are difficult-to-measure losses in human capital generated by the breach announcement itself. In the cases of Shirley MacLaine¹¹² and other entertainers,¹¹³ for example, the value of

¹⁰⁷ See *supra* notes 100-04. The difficulty of proving bad faith behavior justifies the use of screening devices as proxies for undesirable conduct. Thus, the demand that plaintiff abandon rights under the original contract or a demand for renegotiation accompanied by unpleasant behavior provides plausible surrogates for the underlying bad faith behavior. See, e.g., *Howard v. Vaughan-Monnig Shoe Co.*, 82 Mo. App. 405 (1900); *Levin v. Standard Fashion Co.*, 11 N.Y.S. 706 (Ct. C.P. 1890); *Williams v. School Dist.*, 104 Wash. 659, 177 P. 635 (1919); *Lemoine v. Alkan*, 33 Philippine 162 (1916).

¹⁰⁸ See, e.g., *Gurney Indus., Inc. v. St. Paul Fire & Marine Ins. Co.*, 467 F.2d 588 (4th Cir. 1972) (absent written information and assurances, decision not to accept substitute performance not unreasonable); *City of Paragould v. Arkansas Light & Power Co.*, 171 Ark. 86, 284 S.W. 529 (1926) (no duty to accept new rate if there is nothing to guarantee performance of the contract).

¹⁰⁹ See, e.g., *Gurney Indus., Inc. v. St. Paul Fire & Marine Ins. Co.*, 467 F.2d 588 (4th Cir. 1972) (owner's refusal to accept substitute performance not unreasonable failure to mitigate); *Huskey Mfg. Co. v. Friel-McLeister Co.*, 84 Pa. Super. 328 (1925) (same).

¹¹⁰ See *supra* text accompanying notes 52-54.

¹¹¹ See, e.g., *Russellville Special School Dist. No. 14 v. Tinsley*, 156 Ark. 283, 245 S.W. 831 (1922) (new offer was "different and inferior"); *Parker v. Twentieth Century-Fox Film Corp.*, 3 Cal. 3d 176, 474 P.2d 689, 89 Cal. Rptr. 737 (1970) (same); *Milage v. Woodward*, 186 N.Y. 252, 78 N.E. 873 (1906) (same); *De Loraz v. McDowell*, 22 N.Y.S. 606 (Sup. Ct. 1893) (same), *aff'd mem.*, 142 N.Y. 664, 37 N.E. 570 (1894); *Clayton-Greene v. De Courville*, 36 T.L.R. 790 (K.B. Div'l Ct. 1920) (same).

¹¹² *Parker v. Twentieth Century-Fox Film Corp.*, 3 Cal. 3d 176, 474 P.2d 689, 89 Cal.

their services is in part measured by the willingness of others to pay for them. Because the market cannot readily assess the kind of contingency that has materialized, it will discount the value of the services after a breach even where the breach was unrelated to the value of the entertainer's return performance. The no-duty-to-deal rule as applied to personal service contracts, then, is best seen as an implicit penalty clause to discourage breach. Because breach in such cases generates difficult-to-prove losses which often cannot be recouped through objective damages, parties negotiating an optimal mitigation scheme would bargain for the additional protection.

2. *Substantial Performance*

The substantial performance rule parallels the qualified duty to deal with the breacher in specialized contexts. Suppose that our Seller installs a compressor on the agreed price terms, but the compressor's aluminum casing is Type B, a lighter alloy than the Type A contractually specified. Unlike the perfect tender obligation imposed on the sale of goods, courts have implied only a "substantial performance" obligation on a defective performance in service or construction contracts.¹¹⁴ The rule of substantial performance—or material breach—assures the breacher of his accrued contractual gains whenever the tender is consistent with the overall scheme of the contract, although deficient in some particulars.¹¹⁵ The doctrine expands the duty to mitigate in specialized

Rptr. 737 (1970) (substitute offer was for dramatic role instead of musical comedy and plaintiff's artistic control over director and screenplay was restricted).

¹¹³ See, e.g., *De Loraz v. McDowell*, 22 N.Y.S. 606 (Sup. Ct. 1893) (defendant's offer to give actress role in another play, but not guaranteeing the agreed time duration, did not bar plaintiff's cause of action), *aff'd mem.*, 142 N.Y. 664, 37 N.E. 570 (1894); *Clayton-Greene v. De Courville*, 36 T.L.R. 790 (K.B. Div'1 Ct. 1920) (actor engaged to play role in play not required to accept another part because his reputation might possibly have been compromised).

¹¹⁴ See, e.g., *Della Ratta, Inc. v. American Better Community Developers, Inc.*, 38 Md. App. 119, 380 A.2d 627 (1977); *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921); Restatement (Second) of Contracts § 237 comment d (1979).

¹¹⁵ If an obligee receives substantially what he bargained for, the breaching obligor does not automatically forfeit his accrued contractual gains, but instead may reap the benefit of his bargain less any losses caused by the breach. See, e.g., *Dixon v. Nelson*, 79 S.D. 44, 50, 107 N.W.2d 50, 55 (1961) (deviations of house construction slight in relation to entire structure and "do not go to the root") Compare *O.W. Grun Roofing & Constr. Co. v. Cope*, 529 S.W.2d 258 (Tex. Civ. App. 1975) (watertight but not uniformly colored roof inconsistent with the general plan) with *Tolstoy Constr. Co. v. Minter*, 78 Cal. App. 3d 665, 143 Cal.

environments by requiring the mitigator to accept a deficient performance, together with objectively measured damages.

The substantial performance doctrine reduces opportunistic claims by softening the breacher-nonbreacher distinction, thereby removing opportunities to exploit inadvertent breaches. Such a rule is sensible in cases such as construction contracts where the circumstances suggest that renegotiation costs otherwise will be substantial. Once construction is substantially underway, the alternatives for both parties become inferior to the existing relationship, thus expanding the bargaining range within which the parties must reach agreement on post-breach adjustments. The obligor will regard removing the half-constructed object from the site and offering it to a third party as vastly inferior to acceptance plus damages because of the costs of removal. Without the substantial performance rule, the owner-obligee would have an incentive to exploit this situation. On the other hand, a minor deviation will not significantly increase the risk that a disappointed obligor can evade his responsibility to the obligee. So long as the performance is consistent with the general purpose or plan of the contract, objective damages will provide an adequate surrogate to most parties for any deficiencies.¹¹⁶ Furthermore, completion of the bulk of the performance reduces the risk of nonsatisfactory breach.¹¹⁷

Rptr. 570 (1978) (a number of relatively small defects in house construction held material breach). See also Restatement (Second) of Contracts § 241 comment b (1979) (There is a need to determine the "extent to which the injured party will be deprived of [his expected] benefit" and "defects affecting structural soundness" are considered material in construction contracts.).

Alternatively, if the breach is material, the doctrine denies the breacher his accrued contract rights, but allows him a claim in restitution. See *Pinches v. Swedish Evangelical Lutheran Church*, 55 Conn. 183, 10 A. 264 (1887); Restatement (Second) of Contracts § 374 (1979).

¹¹⁶ See Restatement (Second) of Contracts § 241(b) (1979) (listing "the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived" as one of the relevant factors in determining whether a breach was material).

The substantial performance rule is not cost free, however. Any reduction in the clarity of the performance standard increases opportunities for evasion and threats of nonsatisfactory breach, particularly where the injured party attaches any idiosyncratic value to performance. See, e.g., *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921). The rule thus encourages the atypical bargainer to design a custom arrangement making full performance an express condition of the return performance. See Restatement (Second) of Contracts § 229 comment b, illustration 1 (1979).

¹¹⁷ Compare Restatement (Second) of Contracts § 241 comment e (1979) ("To the extent

The substantial performance rule, as well as cases imposing a duty to deal in the specialized context, confirms the predictions of our mitigation model. As the market for substitute performance thins, contracting parties prefer expanded mitigation rules and more narrowly confined obligation rules in order to regulate opportunistic behavior. Such a strategy necessarily increases the opportunities for a disgruntled obligor to evade responsibility. Nevertheless, the trade-off reduces net costs if a rule of thumb circumscribes the expanded mitigation duties by isolating the risks of extortion and nonsatisfactory breach.

C. Pre-Breach Mitigation: The Relational Contract

In our discussion thus far, the central problem has been determining the proper trade-off between the benefits of specifying mitigation duties and the consequent dangers. The problem in the relational context, however, is how best to require future action that *cannot* be particularized at the time of contracting. The dimensions of mitigation in such a context are so complex that no predetermined mechanism can be fully successful. When parties enter into a relational contract, frequently one person's performance depends upon the cooperation and performance of another. An optimal relational contract, therefore, would encourage both parties to undertake cooperative midcourse readjustments. The following sections explore and recommend the legal instruments that might achieve this objective.

1. Readjustment Upon Request

Conventional common-law rules do not encourage midcourse adjustments. Although pre-breach events increasing the risk of non-performance give grounds for insecurity, they do not impose any corresponding duty to mitigate.¹¹⁸ Triggering a duty to mitigate only by a clear and unequivocal breach makes sense in the market environment. Any adaptation will involve the acquisition of cover on the market, and, until the time of breach, the obligor is usually

that [the promisee's] expectation is already reasonably secure, in spite of the failure, there is less reason to conclude that the failure is material.") with U.C.C. § 2-612 (1978) (showing that a breach of one installment will not automatically breach the whole installment contract).

¹¹⁸ See *supra* text accompanying notes 50-54.

better situated to assess the benefits of such cover than is the obligee.

Specialization raises additional adjustment possibilities, however. In addition to external cover by actions on the market, the parties have differing capacities to undertake *internal* adjustments. Internal readjustment, unlike traditional "cover" from outside parties, is effected by an obligee's rearrangement of his own affairs. Thus, it might involve altering production schedules to accommodate the increased risk of breach, or adjusting requirements to accept imperfect or otherwise altered performance. For example, our Buyer may be able to reduce the labor strike's expected costs by arranging to install adjustable windows or by delaying occupancy until the strike is settled.

The conventional common-law scheme discourages renegotiation for such pre-breach adjustment because an obligor's request to renegotiate also creates insecurity—potentially triggering an unintended and undesired determination of breacher status.¹¹⁹ For instance, Seller may prefer to gamble on settlement of the strike to avoid being assigned breacher status, thereby forfeiting his gains from the contract. The mitigation principle, in contrast, would require a rule authorizing a pre-breach readjustment request that does not also invoke the insecurity mechanism. The obligor would be required under such a rule to pay for any requested adjustment regardless of whether he ultimately breaches or performs. Because adjustment would be undertaken on credit, the rule would entitle a mitigator to demand security to protect against the risk of non-satisfactory breach. Although particular contracting parties might incorporate such a procedure into their agreement, a preformulated rule can induce similar cooperative readjustments.

2. *Hadley v. Baxendale Extended*

Legal solutions to pre-breach adjustment problems must respond to the related issue of information exchange prior to breach. Assume, for example, that while making the calibrations necessary to design the compressor, Seller observed but did not react to the

¹¹⁹ Once a contract is concluded, both parties will be reluctant to engage in pre-breach adjustment. The mitigation request operates as a forced loan the nonbreacher may be reluctant to extend. Similarly, the breacher may lack the incentive to adjust, preferring instead to place the onus on the nonbreacher.

fact that Buyer was constructing a laboratory in which sensitive research experiments were to be thermostatically controlled. Assume further that, once the system was operational, malfunctions in the laboratory's automated control processes caused \$100,000 worth of experiments to be ruined. Upon examination, Seller discovered that the compressor's thermostat was not calibrated with sufficient precision to control experiments of such sensitivity and thus the control processes malfunctioned. Accurate calibration is sometimes difficult, but imprecise settings of that magnitude are usually harmless. Buyer, unaware that thermostatic calibrations were so crucial, had not indicated the sensitive nature of his research projects at the time of contract. Seller therefore argues that he will be responsible for any ordinary damages, but not for the \$100,000 worth of ruined experiments which he claims were unforeseeable consequential damages.

Seller's argument under conventional contract rules seems powerful. *Hadley v. Baxendale*¹²⁰ limits an obligor's responsibility for the consequences of breach to those needs and circumstances he had reason to know at the time of contracting. This would include all ordinary consequences, but an obligor must be made aware of special or unforeseeable circumstances at the time the bargain is struck.¹²¹ Unfortunately, in a specialized context, an obligor's extralegal incentives may not motivate him to disclose subsequently acquired information.¹²² Of course, disclosure is often made without legal compulsion. But our Seller may be reluctant to disclose information that could discourage Buyer from going through with the contract, given that Seller's contractual performance is not readily marketable elsewhere. Absent some directive rule, the parties may not achieve optimal mitigation.

Formulating the appropriate disclosure rule presents problems, however. Any attempt to particularize the obligation in advance

¹²⁰ 9 Ex. 341, 156 Eng. Rep. 145 (1854).

¹²¹ See *id.*

¹²² See Klein & Leffler, *supra* note 29. Clearly, concern with reputation, goodwill, and the avoidance of contractual disputes encourages disclosure of information casually acquired during the course of performance even without a legal rule. Concern with repeat business, however, may not be a consideration in the specialized context. Rights accrued under a one-shot contract with little likelihood of replication may be more valuable than guarding against a risk that may not materialize, particularly when, as here, disclosure would sacrifice the gains from an already concluded exchange.

fails because of its inapplicability to most contractors. A more promising approach is to extend *Hadley v. Baxendale* to all those particular needs of which an obligee is unaware, if the obligor has reason to know of them at any time before performance is tendered. Thus, Seller's failure to warn Buyer would be a breach of an implied duty to "rescue" a contracting partner.¹²³ Under such a "last clear chance" formulation, Seller would be responsible for the ruined experiments because he had reason to know of the consequences of improper calibration—and of Buyer's ignorance—prior to installation.¹²⁴ Extending the reach of *Hadley v. Baxendale*

¹²³ Courts might impose an obligation to disclose post-contract information under conventional tort doctrine as a special relationship justifying a duty to rescue. The contractual relationship limits the scope of responsibility problems that would plague any broadly based tort rule. See Ames, Law and Morals, 22 Harv. L. Rev. 97, 111-13 (1908); Epstein, A Theory of Strict Liability, 2 J. Legal Stud. 151, 198-200 (1973).

The cases in which courts impose a duty to rescue involve special relationships functionally equivalent to the relational contract. For example, courts have imposed a duty on a psychiatrist to inform a prospective victim of his patient's intent to assault her, *Tarasoff v. Regents of Univ. of Cal.*, 17 Cal. 3d 425, 551 P.2d 334, 131 Cal. Rptr. 14 (1976), and on a carrier to warn a foreign passenger of the racial problems in the South, *Bullock v. Tamiami Trail Tours, Inc.*, 266 F.2d 326 (5th Cir. 1959). Similarly, a special relationship has been found between a baseball club and its patrons, *Lee v. National League Baseball Club*, 4 Wis. 2d 168, 89 N.W.2d 811 (1958), and between a tavern owner and his paying customers, *Stachniewicz v. Mar-Can Corp.*, 259 Or. 583, 488 P.2d 436 (1971).

Imposing a duty to rescue in some cases, but not all, is analogous to the legal enforceability of serious promises. The variable that best explains the enforceability of a promise is the context in which the promise is made. Goetz & Scott, *Enforcing Promises*, supra note 5, at 1273-88. Promises made in a reciprocal context—one which is conducive to cooperative adjustments between the parties—are generally enforceable. Although legal enforcement increases the reliability of promises already made, it decreases the supply of beneficial future promises. In nonreciprocal contexts, in which extralegal sanctions are high and cooperative adjustments are unlikely, the imposition of legal liability may decrease the supply of future promises by more than it increases the reliability of promises already made. Such concerns disappear in a reciprocal context because the increased reliability of a promise is paid for by the return promise. A promisee can always extract a new promise from a reluctant promisor by increasing the price he is willing to pay. See *id.* at 1284-86.

Similarly, tort law continues to deny any obligation to warn, gnard, or rescue an imperiled victim in nonreciprocal contexts because imposing liability may well discourage the supply of future rescuers (inducing potential rescuers to avoid situations that may call for assistance) by more than it increases the assurance of assistance in those cases where the duty clearly applies. The special relationship cases are all distinguished by the ability of potential rescuers and victims to adjust anticipatorily in order to accommodate legal liability. Thus, the tenant, the bus passenger, or the owner of a complex construction project can overcome any reluctance by a potential rescuer by offering additional compensation in advance. *Id.*

¹²⁴ The doctrine of last clear chance permits either a helpless or an inattentive plaintiff to recover for negligently caused harm notwithstanding his own contributory negligence. See Restatement (Second) of Torts §§ 479-80 (1964). A helpless plaintiff would rarely be found

would induce an obligor to disclose information which he knows to be relevant, but it would not encourage the *discovery* of information necessary for optimal adaptations. Indeed, the imposition of liability actually discourages investment in the acquisition of information that the mitigation principle would otherwise require.¹²⁵

3. *An Implied Obligation to Use Best Efforts to Mitigate*

Given the complexity and uncertainty characteristic of the relational context, a more elaborate pre-breach mitigation rule that attempts to encourage affirmative adjustments would be ill-suited for any particular contractual combination. Perhaps the only feasible state-supplied norm, therefore, is a best efforts requirement to minimize costs whenever a specialized performance makes the specification of mitigation duties impractical.¹²⁶ Under a best efforts duty, both parties will be compensated in advance, through the contractual allocation of risks and benefits, to undertake all future adjustments necessary to minimize joint costs. This obligation requires that each party exert the same level of efforts as

in the contract context, but an inattentive plaintiff often would be. Thus, Restatement (Second) of Torts § 480 (1964) provides that an inattentive plaintiff can recover for harm caused by the defendant's negligence if:

the defendant

(a) knows of the plaintiff's situation, and

(b) realizes or has reason to realize that the plaintiff is inattentive and therefore unlikely to discover his peril in time to avoid the harm, and

(c) thereafter is negligent in failing to utilize with reasonable care and competence his then existing opportunity to avoid the harm.

Id. See also *Merrill v. Stringer*, 58 N.M. 372, 271 P.2d 405 (1954); *Greear v. Noland Co.*, 197 Va. 233, 89 S.E.2d 49 (1955); *McCormick v. Gilbertson*, 41 Wash. 2d 495, 250 P.2d 546 (1952).

¹²⁵ See *Kronman*, supra note 5; *Levmore, Securities and Secrets: Insider Trading and the Law of Contracts*, 68 Va. L. Rev. 117 (1982).

¹²⁶ Frequently, parties to relational contracts undertake best efforts obligations explicitly, but such provisions merely confirm the responsibility generally implied by law in the absence of specific agreement. Both common-law courts and the Uniform Commercial Code thus imply an obligation on a distributor to use best efforts to promote sales in any exclusive dealing arrangement. See *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88, 118 N.E. 214 (1917); U.C.C. § 2-306 comment 5 (1978). The vulnerability of a seller who grants an exclusive license to distribute his product justifies a best efforts obligation because the distributor controls the volume of sales. A similar vulnerability exists in the *Hadley v. Baxendale* context because neither party can reduce the costs of readjustment contingencies without information controlled by the other. The law should thus impose a best efforts obligation whenever a single contractor controls an action or instrumentality necessary to achieve a cooperative goal. See *Goetz & Scott, Relational Contracts*, supra note 5, at 1114-17.

would a single firm owning both contractual interests.¹²⁷ Because of the difficulty of specifying in advance what that future obligation may entail, however, the parties will face the problem of chiseling. Cases such as Seller's failure to disclose the consequences of imprecise calibration may not present insoluble enforcement difficulties. The responsibility, however, is not merely one to act on information already known. Best efforts also implies a duty to invest in discovering exactly what contingencies might occasion the need for adjustment.

It seems inescapable, therefore, that a best efforts duty to minimize losses requires creative use of an incentive system to reduce the costs of enforcement. A properly calculated contract price can encourage a mitigator to consider the obligor's interest in selecting cost-effective adaptations.¹²⁸ Assume, for example, that a best efforts clause requires Buyer to undertake pre-breach mitigation at Seller's request. The contract further entitles Buyer to a bonus of fifty percent of the savings if mitigation proves successful. Seller would thus request adjustments whenever the prospective gains from adaptation exceed expected costs. Similarly, Buyer would undertake all cost-effective adaptations necessary to earn the maximum bonus. Because Seller's bonus payment is tied to the net savings Buyer achieves, Buyer will make only cost-effective adaptations.

To enforce a percentage-savings scheme, however, the parties will need information on costs and resources that may be difficult to obtain or impractical to monitor.¹²⁹ A predetermined fixed bo-

¹²⁷ See, e.g., *Petroleum Mktg. Corp. v. Metropolitan Petroleum Corp.*, 396 Pa. 48, 51, 151 A.2d 616, 619 (1959) ("[D]efendants had the duty at least to use such effort as it would have been prudent to use in their own behalf if they had owned the receivables, or such effort as it would have been prudent for the plaintiffs to use if they had retained possession of them."). See Goetz & Scott, *Relational Contracts*, supra note 5, at 1111-17.

¹²⁸ See Goetz & Scott, *Relational Contracts*, supra note 5, at 1105-09.

¹²⁹ The difficulty of monitoring and segregating costs and revenues within multi-product firms is one such problem. Monitoring the allocation of joint costs or overhead to prevent such costs from being shifted strategically among various contracts becomes substantially more expensive. These and other monitoring problems have resulted in widely publicized failures by actors Fess Parker, James Garner, and Robert Wagner to recover any gains under putative profit sharing arrangements for seemingly successful television shows such as "Daniel Boone," "Rockford Files," and "Charlie's Angels." See *N.Y. Times*, May 1, 1980, at 1, col. 2. The obligor might also pad costs to disguise his true savings and deny any bonus to the mitigator. Cost padding has many and subtle manifestations that are hard to discover and still harder to prove.

nus or penalty, in contrast, would alleviate monitoring problems while still encouraging appropriate adaptations by both parties. For example, the parties could set a \$1,000 bonus for any successful, pre-breach adjustment performed on request. Because the predetermined bonus or penalty is a fixed sum, each party knows in advance the consequences of any adjustment option. Each will thus be encouraged to pool information and then select an efficient adaptation strategy.¹³⁰ Furthermore, because the obligor pays for the adaptations, a modest threat or side payment should discourage opportunistic behavior in most cases.¹³¹ Regardless of the care with which the sum is calculated, however, any fixed-sum payment scheme designed on average to be appropriate will tend always to be "wrong" in the particular situation that develops. Post-contractual renegotiations resolving this distortion will be the "error costs" of fixing the sum.

The importance of specially designed incentive systems in the relational context supports granting the parties freedom to choose the arrangement which best serves their contractual purposes. Courts have increasingly tolerated particularized agreements in specialized contexts, generally enforcing liquidated damages clauses, for example, when negotiated between relational contractors.¹³² Failure to identify explicitly the specialized environment as

¹³⁰ See Cooter, *Unity in Torts, Contracts, and Property: The Model of Precaution* (unpublished paper 1983) (copy on file with the Virginia Law Review Association). The fixed bonus or penalty can be illustrated with an example. Assume that the contract specifies a \$1000 bonus for any pre-breach adjustments successfully adopted. Presumably, the parties would carefully estimate the amount of the bonus to approach but not equal the gains anticipated from pre-breach adjustments. Under such a contract, Seller would request adjustments whenever the prospective gains from adaptations exceed the amount of the bonus. Buyer would have the appropriate incentive to supply information and undertake any requested adaptations at the least cost necessary to earn the fixed bonus.

¹³¹ If the bonus payment is lower than the costs of mutually beneficial adaptations, the mitigator will not voluntarily undertake cost-effective adjustments without additional compensation. Alternatively, the performing party will not request cost-effective adjustments where the benefits are less than the bonus absent a renegotiation. The parties are not required, of course, to select a single incentive payment, but may instead key the amount of any bonus or penalty to particular contingencies. For instance, the parties can agree to one bonus for adjustments required because of delay in construction and another for defective materials. See Goetz & Scott, *Relational Contracts*, *supra* note 5, at 1099-1100.

¹³² See, e.g., *Penbroke v. Gulf Oil Corp.*, 454 F.2d 606 (5th Cir. 1971) (court had no power to look into reasonableness of liquidated damages provision); *Reed & Martin, Inc. v. Westinghouse Elec. Corp.*, 439 F.2d 1268 (2d Cir. 1971) (liquidated damages of 1% of the contract price). But see *City of Rye v. Public Serv. Mut. Ins. Co.*, 34 N.Y.2d 470, 315 N.E.2d

the critical variable, however, invites continuing challenges to such arrangements despite the more tolerant judicial attitude.¹³³ Liquidated damages agreements continue to be scrutinized under the common-law requirement that they reasonably estimate the gains and losses anticipated by the parties. But it may be the very independence of the liquidated damages payment system from objectively assessed losses which motivates both parties to adopt such provisions. In sum, although the courts have de facto relaxed the "reasonable forecast" requirement when specialized contracts are involved, the threat of litigation continues to restrain parties, even when the actual prospect of invalidating a particular clause may be quite small.

D. Mitigation and Multiple Breach

The interaction between mitigation and multiple breach is the final and most complex problem raised in the relational contract setting. The problem of multiple breach can arise, for example, in complicated construction projects where parties arrange the various stages of construction to reduce any disruptions caused by unplanned difficulties. Contracts in such situations often assign extra time, or a "float," to the sequence of individual performances. The float attached to any single performance is the maximum delay allowed before the delay causes a bottleneck effect, delaying subse-

458, 358 N.Y.S.2d 391 (1974) (\$200 per day and \$100,000 maximum for delay in completion of building complex held void as a penalty). The court in *City of Rye* stated: "The most serious disappointments in expectation suffered by the city are not pecuniary in nature and therefore not measurable in monetary damages." *Id.* at 473, 315 N.E.2d at 458, 358 N.Y.S.2d at 394. See also *Gorco Constr. Co. v. Stein*, 256 Minn. 476, 99 N.W.2d 69 (1959); J. Sweet, *Legal Aspects of Architecture, Engineering and the Construction Process* 400-08 (2d ed. 1977).

¹³³ In view of the general enforceability of liquidated damages clauses in relational contracts, the number of challenges to such provisions under the reasonable estimate criterion is quite remarkable. In addition to the cases cited supra note 132, see, e.g., *United Order of Am. Bricklayers & Stone Masons Union No. 21 v. Thorleif Larsen & Son, Inc.*, 519 F.2d 331 (7th Cir. 1975); *In re Plywood Co.*, 425 F.2d 151 (3d Cir. 1970); *Southwest Eng'g Co. v. United States*, 341 F.2d 998 (8th Cir.), cert. denied, 382 U.S. 819 (1965); *Bruno v. Pepperidge Farm, Inc.*, 256 F. Supp. 865 (E.D. Pa. 1966); *Oldis v. Grosse-Rhode*, 35 Colo. App. 46, 528 P.2d 944 (1974); *Norwalk Door Closer Co. v. Eagle Lock & Screw Co.*, 153 Conn. 681, 220 A.2d 263 (1966); *H.J. McGrath Co. v. Wisner*, 189 Md. 260, 55 A.2d 793 (1947); *Norman v. Durham*, 380 S.W.2d 296 (Mo. 1964); *Nu Dimensions Figure Salons v. Becerra*, 73 Misc. 2d 140, 340 N.Y.S.2d 268 (Civ. Ct. 1973); *Northwest Collectors, Inc. v. Enders*, 74 Wash. 2d 585, 446 P.2d 200 (1968); *S.L. Rowland Constr. Co. v. Beall Pipe & Tank Corp.*, 14 Wash. App. 297, 540 P.2d 912 (1975).

quent performances and, hence, the whole project. If there is no float available to a performance, that performance is said to be on the "critical path."¹³⁴ The performance schedule assigns a position to each subcontractor's performance and is constantly revised in order to determine what sequences have become "critical."¹³⁵

Assume that our Buyer initially scheduled his construction project with substantial float allowances for most activities and that, according to the architect's plan, Seller was about thirty days removed from the critical path. Assume further that modifications requested by Buyer in the air conditioning system then absorbed fifteen days of the float and a subsequent additional delay by an electrical subcontractor placed Seller on the critical path. In other words, prior delays exhausted the time cushion surrounding Seller's performance that would have allowed delay without holding up the whole project. Assume finally that Seller delayed his own performance five days beyond the contract schedule causing project losses of \$25,000. Under these circumstances, the argument urging nonliability is clear. Earlier parties' use of the float contrib-

¹³⁴ The DuPont company developed the critical path scheduling method in cooperation with Remington Rand between 1956 and 1958. The method proved superior to the conventional bar chart method of scheduling work because it displayed the interrelationships and interdependence of the various activities controlling the progress of construction. Numerous public and private construction projects now use the method. See Wickwire & Smith, *The Use of Critical Path Method Techniques in Contract Claims*, 7 Pub. Cont. L.J. 1 (1974).

¹³⁵ Wickwire and Smith have stated:

[T]he critical path represents the longest chain of interrelated activities (in terms of time) through the diagram from the beginning to the end of the project. Since this chain of activities will take the longest to complete, it is "critical" to the completion of the project.

Basic to the CPM theory is the principle that if one of these 'critical' activities is delayed by one day, and no pressure is applied to the schedule or critical activity via resequencing . . . or acceleration, the entire project will be delayed. Of course, there are a great number of other activities which are not on the critical path. These side paths of activities on the network contain excess time, usually called float or slack

Nonetheless, activities off the critical path are also important since they can become critical to the completion of the project. For example, an activity on a side path, which is a condition precedent to the commencement or completion of an activity on the critical path, will become critical when the time taken for a specific activity exceeds both the time allocated for its normal completion and the float time for the activity. In such circumstances the activity automatically becomes critical since it has become a restraint to the commencement or completion of the activity upon the critical path.

Id. at 3-5.

uted substantially to the consequences of delay, and resulting losses are attributable to these factors.

Resolution of the dispute requires that ownership of the float be determined. One argument contends that, absent a contrary agreement, the float should be regarded as a management tool available for the use of every contractor.¹³⁶ This debate over property rights in the float is typically framed in distributional terms. The prevalence of contract clauses withdrawing a contractor's float rights is sometimes explained from such distributional viewpoints in terms of the project owner's alleged bargaining superiority.¹³⁷ A more persuasive explanation for such particularized agreements lies in the inefficiencies that individual contractor control of the float would generate. If the float is equally available to every contractor, then the float will constitute communal property—costless to any

¹³⁶ This conclusion is principally based on the established custom—particularly in government contracts—that the contractor is entitled to schedule his own work. For example, in *Joseph E. Bennett Co.*, 72-1 B.C.A. (CCH) ¶ 9364, at 43,467 n.7 (Mar. 8, 1972), the court stated:

Those paths that do not lie on the critical path have a certain flexibility in that there is a difference between the earliest and latest expected times for a particular event. This difference, called "total float" in CPM, allows the manager latitude in the scheduling of non-critical activities that originate or terminate at that event, and to effect trade-offs of resources to shorten or control his project.

Id. at 43,467 n.7. See also *Stagg Constr. Co.*, 69-2 B.C.A. (CCH) ¶ 7914 (Sept. 29, 1969), on reconsideration, 70-1 B.C.A. (CCH) ¶ 8241 (Apr. 14, 1970); *Heat Exchangers, Inc.*, 1963 B.C.A. (CCH) ¶ 3881 (Oct. 8, 1963). But see *Blackhawk Heating & Plumbing Co.*, 75-1 B.C.A. (CCH) ¶ 11,261 (Apr. 30, 1975), on reconsideration, 76-1 B.C.A. (CCH) ¶ 11,649 (Dec. 15, 1975).

¹³⁷ See Comment, "No Damage" Clauses in Construction Contracts: A Critique, 53 Wash. L. Rev. 471 (1978). The distributional analysis of such contract clauses is perhaps explained by the large number of relational contracts to which the government is a party. For an example of a particularized clause assigning rights in the float to a third party decisionmaker under a time extension mechanism, see recent Post Office and GSA contract specifications:

Float or slack is defined as the amount of time between the early start date, and the late start date, or the early finish date and the late finish date, of any of the activities in the NAS schedule. Float or slack is not time for the exclusive use or benefit of either the Government or the contractor. Extensions of time for performance required under the Contract General Provisions entitled, "CHANGES," "DIFFERING SITE CONDITIONS," "TERMINATION FOR DEFAULT-DAMAGES FOR DELAY—TIME EXTENSIONS" or "SUSPENSION OF WORK" will be granted only to the extent that equitable time adjustments for the activity or activities affected exceed the total float or slack along the channels involved.

Wickwire & Smith, *supra* note 134, at 41 n.76.

one contractor and therefore overused.¹³⁸ The costs of delay can be effectively internalized only by assigning exclusive property rights in the float to a single contracting party to whom other contractors are accountable. Thus, allocation of exclusive rights to the owner (or the general contractor, the architect, or any other single party) will result in efficient adaptations, the benefits of which can be shared prospectively at the time of contracting. Furthermore, assuming that the owner (or his agent) generally enjoys a comparative advantage over individual contractors in monitoring the use of the float, assignment of the rights to him increases their value.¹³⁹

Even where a contract or preformulated legal rule clearly assigns rights in the float, multi-party contracts create a vexing enforcement problem. In the Seller-Buyer construction dispute, for example, three different types of delay to the side path activity exhausted the float. Furthermore, but for the delay of any single party, the actions of the other two parties would not have resulted in any actual delay of the project.¹⁴⁰ Clearly, Seller should not be held solely responsible for the delay costs merely because his actions occurred last in time, but difficult problems of proof have prevented courts from resolving the multiple-breach question. One way to ameliorate causation problems is to impose a "comparative negligence" type of liability. For example, courts could require each subcontractor to bear responsibility proportionate to the amount of float each consumed. Unfortunately, the comparative negligence method encounters the same difficulties in its applica-

¹³⁸ As with any valuable, scarce resource, the absence of exclusive property rights leads to overconsumption. See Demsetz, *When Does the Rule of Liability Matter?*, 1 *J. Legal Stud.* 13 (1972).

¹³⁹ For a detailed discussion of the assignment of property rights among creditors based on comparative monitoring skills, see Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 *Yale L.J.* 49 (1982). See also A. Schwartz & R. Scott, *supra* note 65, at 560-63 (discussing and critiquing reduced monitoring costs as an explanation for assignment of rights in secured transactions); Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 *Yale L.J.* 1143 (1979) (suggesting a unified theory for how priorities are designated among secured contracts).

¹⁴⁰ But see *Stagg Constr. Co.*, 69-2 *B.C.A. (CCH)* ¶ 7914 (Sept. 29, 1969) (implicitly sanctioning the proportionate responsibility method of government contract disputes), on reconsideration, 70-1 *B.C.A. (CCH)* ¶ 8241 (Apr. 14, 1970); *Wickwire & Smith*, *supra* note 134, at 41-42.

tion here as it does in torts¹⁴¹ and involves substantial difficulties of proof.¹⁴²

An "expected value" liability rule would offer an alternative to avoid the causation problems of a contributory negligence rule. Each party using a portion of the float would be assessed a probabilistic liability prospectively for increasing the job's expected cost. The expected value solution, however, fails as a legal norm because it requires courts to award liability for a *prospective* loss that may never materialize. Even if the loss does materialize, its magnitude may differ greatly from that predicted by the imposition of liability: the amount of damages assessed in a particular case will always be wrong in retrospect. Although anticipated costs would provide correct incentives to the parties, courts may be troubled by the seeming disproportionality of the prospective measure of damages when viewing the facts of the case retrospectively.¹⁴³

No preformulated rule, therefore, can readily solve the multiple-breach problem. This only reemphasizes the importance of particularized incentive systems to encourage appropriate performance. As indicated previously,¹⁴⁴ liquidated damages for construction delay are generally enforceable even where the amount is not an accurate pre-estimate of objective damages.¹⁴⁵ Thus, parties are free

¹⁴¹ See Rizzo & Arnold, *Causal Apportionment in the Law of Torts: An Economic Theory*, 80 Colum. L. Rev. 1399 (1980); Robinson, *Multiple Causation in Tort Law: Reflections on the DES Cases*, 68 Va. L. Rev. 713 (1982); Wittman, *Optimal Pricing of Sequential Inputs: Last Clear Chance, Mitigation of Damages and Related Doctrines in the Law*, 10 J. Legal Stud. 65 (1981).

¹⁴² For a discussion of the proof problems of multiple causation disputes from the perspective of statistical decision theory, see Kaye, *The Limits of the Preponderance of the Evidence Standard: Justifiably Naked Statistical Evidence and Multiple Causation*, 1982 Am. B. Found. J. 487.

¹⁴³ For a detailed discussion of the broad-based use of expected value liability in multiple causation cases in tort law, see Robinson, *supra* note 141, at 736-67. Professor Kaye argues that an expected liability rule should rarely be substituted for a preponderance of the evidence standard (maximum likelihood of causing the loss) in cases of a single cause but multiple defendants. In true multiple causation cases—such as the hypothetical posed here—he argues that mathematical analysis suggests no preferred rule. Kaye, *supra* note 142, at 513.

¹⁴⁴ See *supra* text accompanying note 132.

¹⁴⁵ The independent decisionmaker can be an architect, arbitrator, or trial judge. See J. Sweet, *supra* note 132, at 398-400. A "no-damages-for-delay" clause, withdrawing alternative remedies for delay, typically accompanies the time extension mechanism. "No Damage" clauses have been criticized as unconscionable. See Comment, *supra* note 137. The provision is better seen as part of a benign strategy for resolving multiple causation problems. Furthermore, the time extension method helps preserve liquidated damages clauses where responsibility is shared by both owner and contractor. See, e.g., *Nomellini Constr. Co. v. State*

to contract explicitly for expected damage liability. In the event of delay, an independent fact-finder could ascertain any increase in expected losses and assign liability accordingly. Indeed, this is analogous to the frequently employed time-extension method of allocating responsibility for delay in construction contracts. Under the time extension technique, all causation questions are referred to such a fact-finder to distribute the float and grant time extensions accordingly.¹⁴⁶ Nevertheless, these devices require a great deal of knowledge about the sequence of performance to encourage appropriate performance without exploitation of the float. A number of factors specific to each contract, including the size of the incentive payment and the relative creditworthiness of the parties, will influence the choice of incentive devices. In this case, for example, a bonus system requires the subcontractors to extend credit to the owner, while a liquidated damages clause has the opposite effect.

IV. CONCLUSION

Our analysis has dealt with the puzzling divergence between the cost-minimizing criterion embodied in the mitigation principle and many of the specific rules of contractual obligation that have evolved through the common law. An examination of mitigation rules as part of an interrelated system of contractual obligation reconciles the apparent incompatibilities. The preformulated rules which form the network of contractual rights and duties fall into two distinct categories. The rules governing performance and liability allocate contractual "property rights" by assigning risks to one party or the other based on presumed advantages in risk-bearing. Changed conditions, however, require cooperative readjustments by both parties if they are efficiently to achieve the original contractual objective. Rules of mitigation, therefore, authorize an obligor to conscript the adjustment efforts of the obligee in reducing the cost required to satisfy the original performance obligation.

An inherent tension lurks in any system of rules designed both to assign risks and encourage cooperative readjustment. This tension influences how parties and the law reduce the theoretical

ex. rel. Department of Water Resources, 19 Cal. App. 3d 240, 96 Cal. Rptr. 682 (1971).

¹⁴⁶ See cases cited *supra* note 132. See also J. Sweet, *supra* note 132, at 404-08.

principle of mitigation to actual practice. A well-developed market for substitute performances substantially lessens the marginal benefits derived from cooperative readjustment. Furthermore, the market effectively restrains uncooperative behavior whenever mutual adjustments are cost-beneficial. Preformulated mitigation rules are thus narrowly circumscribed to render the initial performance obligation more definitive and enforceable. In contracts for specialized performance, however, the absence of a market for substitutes increases the need for legal rules to encourage cooperative behavior. Although many mitigation rules demonstrate a sensitivity to the market variable, absence of an explicit acknowledgment of its role tends to impose excess uncertainty costs on contracting parties.

The uncertainty and complexity characteristic of the relational context prevents the specification of clear rules to guide future behavior. If the law chooses to assist parties in relational environments, it is left with essentially three choices. First, legal rules can provide clearly articulated general standards of obligation such as the "best efforts" duty of cooperation in a mutually beneficial enterprise. Second, the legal system can grant wide latitude to individual bargainers in such environments to negotiate particularized agreements. Finally, the law can develop more specialized norms as preformulated rules for particular varieties of relational contracts. Although the doctrine of substantial performance is one example of judicial willingness to craft rules of limited application, there are many more complex contractual arrangements susceptible of predefinition and categorization. Indeed, specialized rulemaking could be extended to reach the individually tailored arrangement. One of the explanations for the hesitancy of contracting parties to craft such creative mechanisms themselves is that individual parties bear the full costs of investing in cost-saving rules, but they cannot reap the social benefits. Such mechanisms are thus underproduced in the market because the legal system retains the monopoly on meaning and interpretation. An appropriate goal for contract law may therefore be the development of a legal "dictionary" of clearly defined and understood terms and conditions that individual bargainers can select without bearing the uncertainty costs of future interpretation and enforceability.