Michigan Law Review

Volume 83 | Issue 2

1984

The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies

Thomas S. Ulen
University of Illinois

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Contracts Commons, and the Legal Remedies Commons

Recommended Citation

Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341 (1984).
Available at: https://repository.law.umich.edu/mlr/vol83/iss2/3

This Article is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

THE EFFICIENCY OF SPECIFIC PERFORMANCE: TOWARD A UNIFIED THEORY OF CONTRACT REMEDIES†

*Thomas S. Ulen**

TABLE OF CONTENTS

INTRODUCTION 342
I. EFFICIENT BREACH 344
II. MARKET AND SELF-HELP REMEDIES FOR BREACH OF CONTRACT 347
A. *Market Forces: Reputation* 347
B. *Self-Help Enforcement* 349
III. LEGAL REMEDIES FOR BREACH OF CONTRACT 356
A. *Restitution* 356
B. *Reliance* 358
C. *Expectation* 360
IV. THE EFFICIENCY OF SPECIFIC PERFORMANCE 364
A. *The Role of Transaction Costs in Determining Contract Remedies* 366
B. *The Effect of Specific Performance on Formation (Pre-Breach) Negotiation Costs* 371
1. *The Relationship of Current Specific Performance Rules to Stipulations in Voluntary Exchanges* 371
2. *Contract Formation Costs with Specific Performance Available as a Stipulated Remedy and as the Routine Court-Imposed Remedy* 376
C. *Post-Breach Costs and Specific Performance* 379
1. *Transaction Costs, Again* 379

† I should like to thank Dan Farber of the University of Minnesota Law School and John Lopatka of the University of Illinois College of Law for their great help. Participants in the Contracts Seminar at Boalt Hall, University of California, Berkeley; the Faculty Workshop, Department of Economics, University of California, Davis; the Faculty Workshops in the Department of Economics and in the Law School, Louisiana State University; and Industrial Organization Workshop, Department of Economics, University of Illinois, all provided stimulating forums and helpful comments on earlier drafts of this paper. I owe a special debt to Thomas Wippman, Lon Carlson, Eric Blomquist, and David Waimon for their invaluable research assistance.

* Associate Professor of Economics and Visiting Associate Professor of Law, University of Illinois. A.B. 1968, Dartmouth College; B.A. 1972, University of Oxford; Ph.D. 1979, Stanford University. — Ed.

2. *Court Costs* 383
3. *Relative Cover Costs* 385
4. *Mitigation* 389
5. *Consequential Damages* 394
D. *Defenses* 396
1. *Impossibility* 397
2. *High Supervisory Costs* 398
SUMMARY AND CONCLUSION 401

INTRODUCTION

By invoking the notion of economic efficiency, economists and legal scholars have recently made great headway in developing a new and unified theory of contractual relationships.[1] The key advance was the economists' recognition that there are circumstances in which at least one party can be made better off, without making anyone worse off, by one party's breaching rather than performing a contractual promise.[2] This insight suggested that long-established rules for forming and enforcing contracts should be reexamined to see to what extent they fostered or hindered the efficient exchange of reciprocal promises.

The law, it has been urged, should not hinder the breaching of contracts where the breach offers a Pareto-superior outcome.[3] This view suggests that a contract should not be enforced at law solely because to break it is morally repugnant, a repudiation of one's solemn oath. Justice Holmes made the same point without the aid of economic analysis, *viz.*, that the common law should move away from a moral interpretation of contract:

> The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, and nothing else. If you commit a tort, you are liable to pay a compensatory sum. If you commit a contract, you are liable to pay a compensatory sum unless the prom-

1. The best attempt to integrate economic efficiency into the fundamentals of contract law is Eisenberg, *The Bargain Principle and Its Limits,* 95 HARV. L. REV. 741 (1982); *see also* R. POSNER, ECONOMIC ANALYSIS OF LAW 65-98 (2d ed. 1977); Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract,* 89 YALE L.J. 1261 (1980). For a collection of relevant articles, see THE ECONOMICS OF CONTRACT LAW (A. Kronman & R. Posner eds. 1979) [hereinafter cited as POSNER & KRONMAN].

2. The original statements of the relationship between economic efficiency and breach of contract are Birmingham, *Damage Measures and Economic Rationality: The Geometry of Contract Law,* 1969 DUKE L.J. 49, and Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency,* 24 RUTGERS L. REV. 273 (1970); *see also* Barton, *The Economic Basis of Damages for Breach of Contract,* 1 J. LEGAL STUD. 277 (1972).

3. A Pareto-superior outcome is one in which, by comparison to some original position, no one is, in his own estimation, worse off and at least one person is, in his own estimation, better off. *See, e.g.,* H. KOHLER, INTERMEDIATE MICROECONOMICS 417-36 (1982).

ised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it advantageous to get as much ethics into the law as they can.[4]

If we agree with Holmes and accept for the time being that contractual relations and breach of contract should be evaluated on efficiency grounds, we are led to consider, inter alia, the efficiency characteristics of various remedies for breach. We should invoke those remedies that encourage breach when breach is Pareto-superior to performance and discourage it otherwise. There is a long distance, however, between simply stating this goal with regard to remedies and deciding which among the numerous remedies is the most efficient.

The bulk of the scholarship on efficient remedies has concerned the award of money damages, and a consensus has been reached on the form of damages that is most likely to promote economic efficiency.[5] Alternatives to money damages have not received the same attention from lawyers and economists who have written on the efficiency aspects of contract law. For example, specific performance, the most notable alternative form of court-imposed remedy for breach of contract, has only rarely been subjected to the same sort of scrutiny under the efficiency criterion as has money damages.[6] Nor has there been sufficient attention paid to what might be called party-designed or self-help means of achieving enforcement of value-maximizing reciprocal promises through, for example, liquidated damage clauses, arbitration, and bonding. Nor has there been enough written on the role that market forces, such as a regard for one's future business reputation, might play in mitigating inefficient breach of contract.

The purpose of this essay is to begin the development of an integrated theory of contract remedies by delineating the circumstances under which courts should simply enforce a stipulated remedy clause or grant relief to the innocent party in the form of damages or specific performance. The conclusion, in brief, is that in the absence of stipulated remedies in the contract that survive scrutiny on the usual formation defenses, specific performance is more likely than any form of money damages to achieve efficiency in the exchange and breach of reciprocal promises. If specific performance is the routine remedy for breach, there are strong reasons for believing, first, that more mutually beneficial exchanges of promises will be concluded in the future and

4. Holmes, *The Path of the Law,* 10 HARV. L. REV. 457, 462 (1897). Holmes reiterated this theme several years later in one of his first Supreme Court opinions, *Globe Ref. Co. v. Landa Cotton Oil Co.,* 190 U.S. 540 (1903).

5. *See, e.g.,* the articles collected in A. KRONMAN & R. POSNER, *supra* note 1.

6. Two significant instances are Kronman, *Specific Performance,* 45 U. CHI. L. REV. 351 (1978), and Schwartz, *The Case for Specific Performance,* 89 YALE L.J. 271 (1979).

that they will be exchanged at a lower cost than under any other contract remedy, and, second, that under specific performance post-breach adjustments to all contracts will be resolved in a manner most likely to lead to the promise being concluded in favor of the party who puts the highest value on the completed performance and at a lower cost than under any alternative.

The argument proceeds by examining the relationship between different contract remedies and the costs imposed on contracting parties and on society at the time that promises are exchanged and during negotiations, if any, after the breach. A central tenet of the argument is that the transaction costs facing parties who have already concluded a contract are less, even if there has been a breach, than the costs of a court's resolving the dispute.

In Part I the notion of an efficient breach is explained and the theoretical literature on the efficiency aspects of remedies for breach other than specific performance are explored. In Part II, I discuss the role of certain nonlegal, market forces (such as reputation) in obtaining efficient breach, the efficacy of self-help measures such as bonding, arbitration, and liquidated damages, and then, in Part III, the traditional measures of money damages — restitution, reliance, and expectation. Part IV makes the case for specific performance as the routine remedy for breach by discussing its effect on contract formation costs and on post-breach negotiation costs. I also discuss what defenses a promisor might be allowed to mount against specific performance and, therefore, under what circumstances courts should award money damages rather than grant equitable relief to the nonbreaching party.

I. EFFICIENT BREACH

There are circumstances in which performance of an otherwise legitimate contractual promise would be inefficient. Suppose, for example, that *A* promises to sell *B* a house for $100,000. Let us assume that *B* values the house at $115,000. Thus, at *A*'s asking price, *B* realizes a consumer surplus of $15,000.[7] Before the sale is completed, *C* offers *A* $125,000 for the same house. Should the law compel *A* to deliver on

7. Consumers' surplus is the area beneath the demand curve and above the market price. It is a measure of the difference between what consumers are willing to pay for various units of a commodity, as measured by the points on the demand curve, and what they in fact paid, as measured by the market price. *See* H. KOHLER, *supra* note 3, at 203-04. In the law and economics literature, this difference between the market price of an item and the consumer's valuation of it is frequently said to be due to the consumer's "subjective valuation." One of the tenets of modern microeconomics is that in a competitive market, the market price will just equal the subjective valuation of only the last, or marginal, consumer to purchase the commodity. All other consumers, called "inframarginal" consumers, place a subjective value on the commodity that is greater than the market price.

his promise to *B*, or should it allow, indeed encourage, him to breach his promise to *B* in order to sell to *C*?

From an economic standpoint the answer is clear. Economic efficiency will be served if resources are allocated to their highest-valued uses while minimizing the cost of reallocation. Thus, if, as previously assumed, efficiency is our goal, contract law should specify a remedy for breach that will lead to ownership of the house by the person who values it the most, and should attempt to reach this result at the lowest possible resource cost.[8] In this case, the house apparently has the greatest value to *C*: we know that he places a value of at least $125,000 on the house; *B*, by assumption, values it at $115,000; and *A* values it at something less than $100,000.

It might be objected that contract law in general and remedies for breach of contract in particular need not serve the goal of economic efficiency. There are, it is true, other worthy goals to guide us in designing rules of contract law.[9] Professor Fried, for example, has recently made out a strong case for basing contractual rules on the morality of promising.[10]

In what follows, I shall use the efficiency criterion to evaluate various remedies for breach of contract. However, that statement should not be taken to mean that I necessarily believe that those who urge different standards for the law are incorrect. At least with regard to remedies in contract law, I believe it to be the case that widely held notions of fairness and morality argue for the same sort of conclusions as emerge from an efficiency analysis.[11] To the extent that this is true, there is no conflict between efficiency and the other norms often urged in the fashioning of contractual remedies.

There is another potential misunderstanding regarding this efficiency analysis that should be dispelled here. When one invokes "economic efficiency," one can be asserting that courts, in applying the usual common law remedies for breach, are motivated, whatever they may say they are doing, by an attempt to promote economic efficiency.[12] Alternatively, one can be urging the courts to adopt the effi-

8. For example, the costs of administering the rule should be as low as possible.

9. A selection of pieces critical of economic efficiency in the law may be found in *Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485 (1980).

10. C. FRIED, CONTRACT AS PROMISE (1981).

11. *See* Linzer, *On the Amorality of Contract Remedies — Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111, 131 (1981).

12. This assertion has been promoted by several authors. *See generally* R. POSNER, *supra* note 1, at 399; Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977); Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977). For the view that the common law process is not necessarily, but only probably, efficient, see Cooter & Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, 9 J. LEGAL STUD.

ciency criterion instead of whatever criterion they have been using.

This difference between description and prescription is familiar to economists as the distinction between positive and normative economic analysis.[13] Positive economics attempts to use the tools of analysis to describe an existing set of circumstances without regard to a particular moral objective. An example is an analysis of the impact on the amount of fixed capital investment in the economy of a change in the rate at which distributed corporate dividends are taxed. Normative economics interjects a moral goal into the analysis and typically seeks to examine what actions will most nearly lead to the attainment of that goal. An example might be an author's argument against a particular tax on the grounds that it adversely affects what he believes to be a desirable distribution of income. Clearly the line between positive and normative economics is often difficult to draw. Moreover, most pitches for particular policies are made on the basis of positive analysis. For example, recent arguments in favor of deregulating certain industries were not made on the basis that regulation is immoral or unfair, but rather on the ground that existing regulatory agencies were costing consumers millions of dollars and unnecessarily increasing the profits of the regulated industries.[14]

The argument of this paper is normative: the courts should make specific performance the routine remedy and, by extension, any stipulated remedy that was not inserted because of fraud, duress, or coercion should be enforced.[15] Those readers who desire more positivism should consider what follows as being the elaboration of a hypothesis, which, before being accepted or rejected, must be confronted with the relevant data.[16]

139, 141-50 (1980). A still less favorable opinion is Epstein, *The Social Consequences of Common Law Rules*, 95 HARV. L. REV. 1717, 1721-23 (1982).

13. The classic statement of the distinction is found in M. FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS 3-43 (1953). *See also* H. KOHLER, *supra* note 3, at 45-46. With regard to the importance of this distinction in law and economics, see R. POSNER, *supra* note 1, at 17-18.

14. *See generally* Joskow & Noll, *Regulation in Theory and Practice: An Overview*, in STUDIES IN PUBLIC REGULATION (G. Fromm ed. 1981). *See also* S. BREYER, REGULATION AND ITS REFORM 2, 200-209 (regulatory waste in the airline industry), 227-28 (in the trucking industry), 244-47 (in the natural gas industry) (1982).

15. Economists are loath to confess to making a normative argument, presumably on the ground that this means that their discipline is less scientific than if their statements were based on more clearly falsifiable assumptions. A persuasive argument that these grounds are nonsensical can be found in McCloskey, *The Rhetoric of Economics*, 21 J. ECON. LIT. 481, 508-12 (1983).

16. *See* notes 51, 57, 63, 65, 151 *infra* and accompanying text for suggestions of types of data to serve this task.

II. MARKET AND SELF-HELP REMEDIES FOR BREACH OF CONTRACT

Before turning to the remedies that a court either enforces, such as liquidated damages or compulsory arbitration, or imposes, such as money damages, it is worth considering what other forces society brings to bear on contracting parties in order to discourage breach of contract.

A. *Market Forces: Reputation*

The most important nonlegal market force is probably reputation. Although no one is certain as to its effectiveness or its power in enforcing contractual performance, there is certainly a strong relationship between a regard for one's reputation and the decision not to breach a contract. For businessmen a reputation among consumers and other businessmen as trustworthy, fair, and dependable is one of the most valuable (and hardest to value) assets that a successful business concern has.[17] All other things being equal, a business prefers to contract with a partner known to have completed his promises promptly and without contentiousness. This was one of the principal findings in the important work of Professor Macaulay.[18]

Similarly, a consumer — say, someone hiring an electrical contractor to perform extensive servicing of his property — prefers that electrician whose reputation for honesty and quality, among other things, is high. The importance of reputation in consumer-business relations arises from two sources: the possibility of repeat purchases and of inter-consumer information exchange. For example, a manufacturer is less likely to breach an implied or explicit contractual warranty if by doing so he is more likely to lose future business from any particular consumer or from those to whom that consumer might communicate his unhappiness with the manufacturer. This suggests that, regardless of the law's stance on breach of contract, the value of lost future ex-

17. Consumers are also surely concerned about damage to their reputation, in the form of their credit rating, that may result from their breach of a contract. For the purposes of this argument, however, I will concentrate on the attitudes toward reputations of businessmen.

18. The seminal work on the actual relationships between the law and business behavior is Macaulay, *Non-Contractual Relations in Business: A Preliminary Study,* 28 AM. SOCIOL. REV. 55 (1963). Professor Macaulay found that within the business community informal, personal relationships between individuals formed the basis for business relationships. The formalities of contract law did not influence the nature or volume of business dealing, save in the most complex exchanges. These results are extended and updated in Macaulay, *Elegant Models, Empirical Pictures, and the Complexities of Contract,* 11 LAW & SOC. REV. 507 (1977). Professor Macaulay did not explicitly mention the influence of reputation on business transactions, but the strong implication of his work is that a good reputation forms an important part of the informal attributes upon which businessmen rely in their relations.

changes owing to a bad reputation may encourage business not to breach its contracts with consumers.[19]

A last, and important, category of transactors to whom reputation is especially important are those who perform personal and professional services. Consider, for example, how important reputation is to a doctor, an accountant, a professional consultant, or a lawyer. A sullied reputation can have such disastrous consequences for those professionals that they often take very great pains to protect and polish the public's perception of them and of their profession. It is, no doubt, this concern for reputation that, in part, lies behind so many professional groups' attempts to regulate the quality of their membership. Because reputation forms such a large part of the assets of professional groups, and because, therefore, all lawyers are, to a degree, tarnished by the bad actions of another lawyer, there is a strong incentive for good lawyers to specify minimum quality standards for the entire profession. It is for this reason that most nonprofessional groups do not undertake the same sort of standard-setting that characterizes groups to which reputation is so valuable.[20]

These considerations suggest that reputation serves as a signal of a long list of desirable characteristics, in the person or business to which the good reputation attaches.[21] The question to be considered is whether the breacher's concern for his reputation or a court-imposed remedy is the more efficient enforcer[22] of contractual promises.[23] We can hypothesize that in those cases in which the value of lost future exchanges is powerful, the market will be an efficient enforcer, and in the cases where the value of lost future exchanges is low, that court-imposed remedies will be more efficient. Unfortunately, the world will probably not divide into these neat categories. The great bulk of cases probably concern circumstances in which competition is powerful

---

19. *See* Nelson, *The Economic Value of Advertising*, in ADVERTISING AND SOCIETY 49-50 (Y. Brozen ed. 1974); Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 620-23, 629-31 (1981). Of course, this only pertains to inefficient breaches. If it is an efficient breach, the consumer by definition cannot be any worse off than if the contract is performed. In other words, the consumer is at least indifferent to whether the contract is performed and may actually prefer breach if the breach is efficient.

20. Leffler, *Physician Licensure: Competition and Monopoly in American Medicine*, 21 J. LAW & ECON. 165, 166-72 (1978). Professor Leffler also finds licensure to be positively related to strong consumer demand for minimum quality in physicians. *Id.* at 181.

21. See H. KOHLER, *supra* note 3, at 302, on the economic theory of market signaling. The literature on this point began with A.M. SPENCE, MARKET SIGNALING (1974), which is still the best monograph on the subject.

22. The concept of efficient enforcer embraces two qualities: promoting only efficient breaches of contracts and minimizing transaction costs involved in making everyone at least as well off after the breach occurs.

23. In Kornhauser, *Reliance, Reputation, and Breach of Contract*, 26 J. LAW & ECON. 691 (1983), reputation is considered as a substitute for a damage rule.

enough to place only a minimal regard for future profitability before the breacher so that some additional, court-imposed measure is necessary.

Even if it were true that reputation and a rule of law were substitutes and not complements, there might be minimal harm in specifying a rule of law to hold in all breach cases, even those where reputation was the more efficient enforcer. This would be especially true if there were substantial costs involved in distinguishing the circumstances in which reputation or a rule of law was the more efficient remedy. This being so, the proper consideration of reputation is as an adjunct to court-imposed relief. We might then enlist reputation as an aid in enforcing efficient breach through other means.

These considerations will be especially important when we come to consider the efficiency aspects of specific performance, most notably where there has been a breach of a personal service contract.[24] It is the general rule that those contracts will not be specifically enforced, principally because of the problems involved in the court's supervising the post-decree performance of the breaching party.[25] If, however, the breacher's regard for his reputation can be relied upon to guarantee his faithful completion of the promise — as it can be because, as noted above, reputation is such an important part of the capital stock of professionals and those who provide personal services — then an objection to specific performance based on the high costs of supervising a personal service contract loses much of its force.

B. *Self-Help Enforcement*

Another noncourt imposed method for controlling contract breach is an enforcement system designated by the parties. At the time a contract is formed the parties may specify what is to be done in the event that either of them breaches the contract. They might, for example, name the sum of money, called liquidated damages, that the breacher will pay to the innocent party; they may designate a manner, other than litigation, in which a dispute about performance can be resolved; or they may leave good faith deposits or performance bonds with a third party and specify that the breacher's deposit is to be paid to the innocent party in the event of a breach.[26] Subject to the usual forma-

---

24. *See* notes 188-95 *infra* and accompanying text.

25. *See, e.g.*, RESTATEMENT OF CONTRACTS, § 379 (1932); RESTATEMENT (SECOND) OF CONTRACTS §§ 366, 367 & comment a (1979).

26. *See generally* Knoeber, *An Alternative Mechanism to Assure Contractual Reliability*, 12 J. LEGAL STUD. 333 (1983). These performance or good-faith deposits discussed by Professor Knoeber as a self-help method of increasing contract compliance should be distinguished from surety bonds. A surety bond, in the form of a performance or payment bond, is a common device

tion defenses, this stipulation forms a part of the contract and is enforceable by a court. There are, however, legal limitations on the ability of contractual parties to stipulate their own remedies for breach of contract: a court will not enforce a liquidated damages clause where the stipulation exceeds reasonably anticipated compensation and contains what appears to be a punitive aspect.[27] Nor will a court enforce an agreement to perform specifically.[28] Nor will a court be bound to enforce a contractual clause that contravenes public policy.[29]

There has been a great deal of reconsideration by economists and lawyers of these limitations on the ability of contracting parties to stipulate their own remedies.[30] There are good reasons for believing that liquidated damages — and other forms of stipulated remedy — should be routinely enforced by the court, even if they appear to contain a punitive element.[31] The reason is that a stipulation in excess of what

---

in the construction industry for protecting promisees and subcontractors from losses arising from a contractor's inability to perform a contractural promise. Such a bond may be interpreted as a self-help method of minimizing losses from a contract breach and, insofar as it raises the cost to the breacher of nonperformance, as a variety of self-help remedy for breach. *See generally* J. SWEET, LEGAL ASPECTS OF ARCHITECTURE, ENGINEERING, AND THE CONSTRUCTION PROCESS 295-311 (2d ed. 1977).

27. U.C.C. § 2-718(1) (1977); RESTATEMENT (SECOND) OF CONTRACTS §§ 356(1), 374(2) (1979).

28. No provision exists in the U.C.C. that grants or denies parties to a contract for the sale of goods the ability to contract for specific performance. Neither does the RESTATEMENT (SECOND) OF CONTRACTS (1979) contain any section expressly denying parties the right to contract for specific performances. Nevertheless, §§ 357-358 indicate that a decree of specific performance is solely within the discretion of the court to grant, and § 359(1) states: "Specific performance or an injunction will not be ordered if damages would be adequate to protect the expectation interest of the injured party." Note, however, that § 359(2) provides: "The adequacy of the damage remedy for failure to render one part of the performance due does not preclude specific performance or injunction as to the contract as a whole." In one example of a private attempt to bind a party to perform specifically, the court, while issuing the contracted-for injunction, denied that they were bound by the contract to issue the injunction. The contract clause specifying specific performance was viewed only as evidence of the parties' intent. *See* Stokes v. Moore, 262 Ala. 59, 77 So. 2d 331 (1955).

It is also possible to contract around this restriction by specifying that in the event of breach the case will be referred to and the parties agree to be bound by the decision of the American Arbitration Association. The rules of that association allow for the arbitrator to decree specific performance. Staklinski v. Pyramid Elec. Co., 6 N.Y.2d 159, 160 N.E.2d 78, 188 N.Y.S.2d 541 (1959).

29. *See, e.g.*, Rockhill Tennis Club v. Volker, 331 Mo. 947, 957, 56 S.W.2d. 9, 19 (1932); Parish v. Schwartz, 344 Ill. 563, 176 N.E. 757 (1931); *see also*, RESTATEMENT (SECOND) OF CONTRACTS § 365 (1979).

30. *See, e.g.*, Clarkson, Miller & Muris, *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351; Fenton, *Liquidated Damages as Prima Facie Evidence*, 51 IND. L.J. 189 (1975); Kaplan, *A Critique of the Penalty Limitation on Liquidated Damages*, 50 S. CAL. L. REV. 1055 (1977); Note, *Liquidated Damages and Penalties Under the Uniform Commercial Code and the Common Law: An Economic Analysis of Contract Damages*, 72 NW. U. L. REV. 1055 (1978).

31. In a recent article Professor Polinsky has examined the abilities of various remedies for breach of contract to allocate the risk of certain contingencies between the promisor and promisee. Polinsky, *Risk Sharing Through Breach of Contract Remedies*, 12 J. LEGAL STUD. 427

appears to be reasonably anticipated compensatory damages may well serve two important functions and serve them more efficiently than would any alternative.

First, the punitive element may be considered as the payment on an insurance contract written in favor of the innocent party by the breaching party. This situation arises where one party to the contract places a high subjective valuation on performance of the contract and the other party is the best possible insurer of that subjective valuation.[32] If the parties are convinced that the clause will be enforced, the contract will be breached only when it is more efficient to breach than to perform. Since this is precisely the result that one wants from a rule of contract law, this is a strong case for the routine enforcement of liquidated damage clauses.[33]

A second reason for allowing punitive stipulated damages is that these may be the most efficient means for one party to convey information about his reliability, his ability to perform, and the like.[34] Consider a construction contract in which the buyer is especially eager to have the project completed by a specified date. Suppose that he is extremely doubtful of the contractor's ability to meet that deadline, but that the contractor is certain of his ability to complete performance by the specified date. It may be that the least expensive way for the contractor to convey to the seller his conviction about his ability to perform is for him to stipulate his willingness to pay seemingly punitive damages for each day beyond the deadline that the project remains uncompleted.[35] In those circumstances, if courts are unwilling

(1983). He concludes that liquidated damages will come closer than will any other remedy to an optimal allocation of risk of loss from breach. *Id.* at 444. I shall return to this article's contentions about the efficiency of other remedies below. *See* text at note 77 *infra*.

32. 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, 579-83 (1977). Professors Goetz and Scott give a delightful example of such a case. In their example an alumnus of a college wishes to charter a bus to follow his school basketball team to a tournament. He places a very high value on being at the game, far more than the bus company's hire price. If the bus company breaches, however, the most he can hope to recover in an action for breach of contract is the bus hire price, which will undercompensate him for his loss. The bus company might be willing, however, to pay the alumnus his subjective valuation of performance in the event of a breach in exchange for a payment in excess of their usual hire price. This excess in price could then be considered as the premium on an insurance policy against breach. *Id.* at 578-79.

33. Of course the usual contract defenses would be retained so that if the self-help clause were truly inequitable it would not be enforced.

34. A. KRONMAN & R. POSNER, *supra* note 1, at 224.

35. This may be particularly important if the buyer's reluctance to believe the contractor was due to the fact that the contractor was new to the business. The contractor could not, therefore, offer any other basis by which the buyer could judge his ability to complete the project on time. If the construction market is so competitive that it is not possible for the new contractor to compete by cutting his price, then his only way of getting the contract may be his willingness to

to allow parties voluntarily to agree to punitive liquidated damages, they force the parties to find a more expensive and, therefore, less efficient way in which to exchange promises.

An argument that has been raised against the routine enforcement of liquidated damage clauses is that such clauses are likely to lead to disputes and, because the judicial resolution of disputes involves at least a partial subsidy from society and because there is no efficiency reason for society to subsidize the resolution of these particular disputes, the law should discourage stipulated damages in excess of reasonably anticipated actual damages.[36] This criticism is misplaced. It is true, if at all, only where the court is disposed to enforce only reasonably foreseeable compensatory damages. Only where the law is unclear about the treatment of punitive stipulated damages is there any inducement to engage in a dispute. If the law routinely enforced liquidated damage clauses, entertaining only the usual formation defenses, there would be nothing to gain from disputing the level of stipulated damages.

In addition, this criticism is misplaced in that the basis of the claim that agreements that tend to promote disputes should not be enforced by the law is the observation that, because legal disputants have to pay only a fraction of the full costs of having a court resolve their dispute, people tend to use courts more than is socially optimal.[37] To the extent that this is true, there are two possible prescriptions for correcting this inefficiency: the first is Professor Rubin's policy of preventing dispute-encouraging agreements; the other is to correct the manner in which disputants pay for a court's resolution of their dispute. I have already argued that there are strong efficiency reasons for allowing punitive stipulations and so there are strong reasons not to adopt Professor Rubin's prescription. A full discussion of the most efficient manner of paying for legal resolution of particular disputes is beyond this paper's scope. Nonetheless, I shall briefly return to the subject below when we discuss the efficiency aspects of specific performance.[38]

There is another criticism sometimes made of liquidated damages

---

pay punitive damages to the buyer in the event of his breach. Without this method of competition the new contractor may find entry impossible.

36. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237, 243 (1981); *see also* Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980). Another element of the argument — an element not stressed by Rubin or Telser — is that penalty clauses heighten the incentive of the breachee to litigate issues that otherwise would not be litigated. Insofar as litigation involves subsidization out of the public fisc, this increased incentive to litigate would, if true, increase the social cost of allowing liquidated damages in excess of reasonably foreseeable losses.

37. Rubin, *supra* note 36, at 239, 240.

38. *See* text at notes 97-98 *infra*.

that contain a punitive element: they may induce performance when the more efficient course is breach.[39] Consider the case in which *A* has contracted to sell *B* 1000 widgets at $10 per widget. For simplicity's sake, let us assume that *B* advances the entire sum of $10,000 to *A* at the time that the contract is formed. The widget industry is very highly competitive and *A* is a recent entrant. To get *B* to purchase from him *A* offered the following liquidated damages clause, to which *B* agreed: if he breached the contract, *A* would return *B*'s $10,000 plus another $10,000. Under the circumstances, the second $10,000 constitutes a punitive element of the stipulated damages in that, because of the competitiveness of the industry, *B* can adequately cover the breach for $10,000. Now suppose that after the contract is formed, *A*'s costs suddenly and unexpectedly increase such that the costs of completing the contract rise to $15,000. To heighten the point being made, let us assume that none of *A*'s competitors' costs rise.

Given all of this, one might argue that it would be inefficient for *A* to perform: he will lose $5,000 and *B* will be no better off than if *A* had breached, had had his $10,000 restored, and had then bought his widgets elsewhere for $10,000. That is, if *A* performs, society loses $5,000 that it would not lose if *A* breached and paid *B* only compensatory damages. But A will not breach. If he breaches, he will be obliged to return *B*'s $10,000 plus the $10,000 penalty to which he agreed. His losses would then be $10,000. This is double what he would lose if he performs the contract. The conclusion is that when stipulated damages exceed compensatory damages, there is an inducement to perform a contractual promise when it would be more efficient to breach.

The argument is incorrect. *A* will not necessarily perform on the contract even in the circumstances given above. The reason is that it is possible for post-breach negotiations to make both parties better off without *A*'s having to produce the widgets. *A* stands to lose $5,000 if he performs. He would prefer to lose any sum less than that and not to perform. *B* would like to have 1000 widgets from *A* or his $10,000 to buy them from anyone else. Anything more than this will be preferred by *B*. Clearly, *B* should be willing to take any sum between $1 and $4,999 to release *A* from his duty to perform. And, importantly, he will be willing to take this sum rather than the stipulated damages of $10,000. The reason is that *A* can prevent *B*'s getting anything at all, over his 1000 widgets, by simply losing $5,000 and performing on

39. Goetz & Scott, *supra* note 32, at 567-68.

the contract. Thus, *A* will not inefficiently perform but will pay *B* some sum to release him from the contract.

It might still be objected, however, that any sum that *A* pays to *B* over $10,000 is a social loss that could have been avoided if only compensatory damages had been stipulated.[40] This is, to an extent, true, but there is a good reason for believing that the sum will be much closer to $1 than to $4,999. *A* can always perform on the contract by simply taking *B*'s $10,000 and buying 1000 widgets from one of his competitors, whose costs, by assumption, did not rise. Thus, the amount over $1 that *A* agrees to pay *B* to release him from the contract can only be equal to the amount of inconvenience that *A* saves by having *B*, rather than himself, purchase the widgets elsewhere.

A last efficiency concern that should be raised against the routine enforcement of liquidated damage clauses that contain a punitive element is that they create an incentive for one party to induce the other to breach the contract because that party will be better off if the contract is not fulfilled. This possibility arises as a companion to the sort of problem discussed above in the widget example. Suppose that the reason for the insertion of the punitive damage clause in the contract is that there is some special value attached to performance by one of the parties.[41] Suppose, further, that before completion that subjective valuation falls because of changed circumstances.[42] The party who placed the initially high subjective value on the contract has an incentive to induce breach of the contract because he will receive a sum that now far exceeds his (subjective) losses from nonperformance.

It is not at all certain, however, that this sort of problem is weighty enough to argue against the routine enforcement of punitive liquidated damages. First, this problem of so-called moral hazard is not likely to arise frequently.[43] Even if it does, the contractual party who is providing the insurance can protect himself against moral hazard in the same way that commercial insurance companies do: *e.g.*, by requiring coinsurance, a deductible, or a higher premium. Second, since there is the incentive for the breachee to induce breach when circumstances

40. It may easily be argued that the payment from *A* to *B* is not a social loss at all but rather a transfer payment, whose effect is distributional but not efficiency-reducing.

41. In the widget example, the penalty clause was designed to convey information to one of the parties about the strength of the other's belief in his trustworthiness.

42. In the alumnus example in note 32 *supra*, the alumnus may discover only after the bus is hired that the starting five of his *alma mater* cannot play. He no longer has an interest in attending the tournament, and he thus has an incentive to induce breach.

43. Moral hazard arises when, after the purchase of insurance, an insuree's behavior becomes more risky than it was before he was insured. An example is someone who stops locking his car after he insures against the loss by theft of his car stereo. *See* H. KOHLER, *supra* note 3, at 310. It is worth noting that instances of inducement to breach are extraordinarily rare.

change, the defendant should be allowed to raise the induced breach in mitigation.[44]

One last point deserves notice here. The literature stresses liquidated damages to the exclusion of any other form of stipulated remedy for breach. In theory, however, there is no reason for contracting parties not to consider binding themselves to perform specifically. Naturally, there are substantial costs to inserting such a clause in a contract: for example, consider the costs of agreeing not to contest an action for specific performance or of agreeing to some burdensome financial alternative unless one specifically performs. There has been only one discussion of this possibility in the literature, and there the principal point was that courts will hesitate to enforce a stipulated specific performance clause.[45] In principle, there is no more reason not to enforce such a clause than there is to enforce any liquidated damages clause not tainted by a valid formation defense. In the absence of legal impediments, parties would insert a stipulated performance clause when the net costs of that clause would be less than those of a stipulated damages clause.[46]

We now have the notion of efficient breach in hand and an idea of the sorts of remedies that are available through either the market, independent of the actions of the contracting parties, or through self-help devices available as a part of the contract.

The strongest market force is probably reputation. It is reasonable to hypothesize that the desire to avoid an adverse reputation can induce some promisors to undertake a breach only where the benefits of that breach exceed the costs, including the costs of a tarnished reputation. Efficiency considerations also argue for the routine enforcement of any liquidated damages clause that is not defeated by a defense of fraud, duress, or coercion. The law's particular objection to penalty clauses is misplaced because agreeing to pay super-compensatory damages in the event of breach may be either the most efficient means of conveying information or the cheapest means of insuring oneself against losses from nonperformance where there is a high subjective valuation placed on performance by one party.

These considerations suggest that a coherent theory of contract remedies — one stressing the efficient exchange of reciprocal promises and encouraging only efficient breach — must specify not only what remedies the court will impose in the event that the parties have not

44. Goetz & Scott, *supra* note 32, at 588.

45. *See* Kronman, *supra* note 6, at 370-71 (discussing Stokes v. Moore, 262 Ala. 59, 77 So. 2d 331 (1955)).

46. *See* text at notes 118-21 *infra*.

done so, but must also indicate how it will treat self-help remedies agreed to by the contracting parties at the time of contract formation. Stipulated damages seek to encourage contracting parties to specify how they wish disputes resolved, and there is every reason to believe that they will stipulate the most efficient remedy, considering all the factors.[47]

III. LEGAL REMEDIES FOR BREACH OF CONTRACT

A. *Restitution*

Legal remedies in the common law of contract remedies seek to protect three interests of the innocent party in a breach of contract.[48] First is the restitution interest. The goal of awarding a restitution interest in damages is to return the innocent party, insofar as possible, to his position before the contract was formed. Thus, any benefits, in the form of money or property, that the innocent party transferred to the breacher between the formation of the contract and the breach are to be returned. This situation typically arises where a contract is only partially fulfilled. The law holds that restitution is to be made to the innocent party even if performance might have resulted in loss to the innocent party.[49]

It is not entirely clear when or why courts prefer restitution to other damage measures. A frequently cited reason for ordering a restoration of values on both sides is to prevent unjust enrichment from breach of contract.[50] Little attention has been given to the possibility of an efficiency reason for preferring restitution to other contract remedies.[51] One possible efficiency explanation is that, in general, it is extremely inexpensive to measure damages in terms of benefit con-

---

47. One of the most important of these factors is accounting for any subjective valuation on performance by one of the parties. Bargaining at the time the contract is formed is more likely than any other alternative method to protect one's subjective value. As I shall argue below, if the measurement of subjective value is attempted only after a breach, there is a strong incentive for the aggrieved party to overstate his subjective value and for the other party to dispute that value.

48. *See* Farnsworth, *Legal Remedies for Breach of Contract,* 70 COLUM. L. REV. 1145, 1147-49 (1970).

49. Bush v. Canfield, 2 Conn. 485 (1818); RESTATEMENT (SECOND) OF CONTRACTS § 373 & comment d (1979); U.C.C. §§ 2-702, 2-703, 2-705 (1977); *see* Sanitary Linen Serv. Co. v. Alexander Proudfoot Co., 435 F.2d 292 (5th Cir. 1970) (a laundry recovered fees paid to an efficiency engineer when no substantial increase in efficiency resulted from his recommendations).

50. *See* RESTATEMENT (SECOND) OF CONTRACTS § 370 comment a (1979); D. DOBBS, REMEDIES 223-27 (1973).

51. *See generally* Mather, *Restitution as a Remedy for Breach of Contract: The Case of the Partially Performing Seller,* 92 YALE L.J. 14, 21-28 (1982) (discussing the comparative efficiencies of expectancy damages and restitution; concludes that when transaction costs are considered, neither is clearly preferable).

ferred, especially in comparison to the other damage measures available to the courts.

However, despite the inexpensive nature of this remedy, restitution as a measure of damages will not necessarily lead to economically efficient breach of contract. Consider, again, the example in which *A* has agreed to sell a house to *B* for $100,000 when *B* values the house at $115,000. If *A* knows that upon breach he will have to pay *B* restitution damages, *A* may breach when economic efficiency would urge him to perform. Suppose that *B* gives *A* a good faith deposit of $5,000 when the contract is formed and that before *A* conveys to *B, C* offers *A* $110,000 for the house. If *A* anticipates that the court will award restitution damages to *B* for breach of contract, *A* will breach, pay $5,000 to *B,* and sell the house to *C.* Because *C* values the house less than does *B* but more than the contractual price, the breach does not lead to a Pareto-efficient reallocation.

Nor is it the case that *B* can protect his subjective valuation arising from completion of the contract by leaving a good faith deposit with *A* that is just equal to the difference between the price he is willing to pay for the house and the contractual price. In this instance, suppose that *B* attempts to protect his subjective valuation by leaving $15,000 with *A*. The fact of the matter is that *A* will still breach if he receives *any* offer above *B*'s $100,000. All *A* is required to do under a restitution formula is to return *B*'s $15,000 in order to place *B* in as good a position as he was prior to the formation of the contract. He is *not* required to place *B* in as good a position as *B* would have been upon *completion* of the contract. Thus, the size of the good faith deposit that *B* leaves with *A* has no bearing on *A*'s decision to breach. It is in *A*'s interest to breach, under the restitution formula, whenever he is offered a higher price than the contractual price agreed upon with *B.* It is *efficient,* however, for him to breach only if he receives an offer that is higher than *B*'s subjective valuation of the house. Since restitution offers no way to induce only this breach, it must be rejected, on efficiency grounds, as the routine contract remedy.[52]

52. This does not mean that there are no grounds other than efficiency for preferring restitution to other remedies. *See, e.g.,* Mather, *supra* note 51, at 36-47 ("Restitution usually serves the liberal purpose of rectifying an involuntary transfer." *Id.* at 47). Nor does it preclude the possibility that restitution might have *some* efficiency characteristics, *e.g.,* its ease of measurement. Professor Harrison has recently suggested that the courts have eschewed efficiency as their guide in dealing with restitution losses. Harrison, *A Case for Loss Sharing,* 56 S. CAL. L. REV. 573, 584-85 (1983). Efficiency argues for assigning losses in their entirety to one or the other party. Courts rarely do this, however, preferring instead to use a criterion of fairness to split the loss.

B. *Reliance*

A second interest of the innocent party that damage measures seek to protect is the reliance interest.[53] Expenses incurred by the innocent party in reliance on the performance of the other party's promise or in preparing to accept the fruits of the contract are recoverable as reliance loss when the contract is breached.[54] The purpose of this measure of damages is to prevent punishing the innocent party for relying on the contract.

In the simple transaction we have been examining between *A* and *B* for the sale of a house for $100,000, suppose that *B*, in anticipation of *A*'s performing the contract, hires a mover, an interior decorator, a painter, and so on.[55] *B*'s reliance on *A*'s promise to convey the house at $100,000 has induced him to spend, say, $8,000. *B* continues to value the house at $115,000. Now comes *C* to bid $110,000 to *A* for his house. If *A* must pay reliance loss to *B* as damages for breaching his contract, then *A* will breach, pay *B* $8,000 in damages, and sell to *C* for $110,000. *A* has increased his profit by $2,000, and in the eyes of the court *B* is no worse off than if he had never entered the contract in the first place. Yet, as with restitution as the damage measure, the breach, where reliance loss is the damage measure, is not necessarily Pareto efficient: the house has not passed to the party who values it most.

However, as compared to restitution, there *is* something to be said in favor of reliance on efficiency grounds.[56] Reliance may be construed as an attempt to protect, and thus to encourage, the efficient timing of expenditures related to performance of the contract. The argument would be that without protection of these reasonable, precompletion expenditures, parties — especially those who have a high degree of risk aversion[57] — would inefficiently wait until full performance before incurring these expenses. The inefficiency is not likely to be large, however, because the cost of that waiting is likely to be minimal and is offset to the extent of interest earned on the funds that

---

53. The original statement of the reliance measure of damages is Fuller & Perdue, *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52 (1936) (Part 1); 46 YALE L.J. 373 (1937) (Part 2).

54. RESTATEMENT (SECOND) OF CONTRACTS § 349 (1979); U.C.C. §§ 2-704, 2-708, 2-710 (1977).

55. Note that because these expenses confer no benefit on *A*, they are not recoverable as restitution damages.

56. *See* Goetz & Scott, *supra* note 1 at 1267-70, 1305-09.

57. Economists distinguish different attitudes toward risk: risk preference, risk neutrality, and risk aversion. It is customary to assume that most consumers are risk averse. A person who is risk averse will usually pay money to avoid having to bear risk arising from uncertainty. See H. KOHLER, *supra* note 3, at 290-93 for a more formal definition.

would have been used to make the earlier purchases. If the law relieved an innocent contractual party of the risk of this loss, he would be willing to forego the interest earned on his funds in order to make his expenses at an earlier date. If there are no inefficiencies induced by the reliance measure and if it is a relatively inexpensive damage measure to compute, the benefits of making this the routine remedy may exceed the costs.

It might be objected that those with a high subjective valuation on performance might be induced to time their expenses inefficiently under the reliance measure. If it were well known that the routine remedy for breach was the payment of any expenses incurred in reasonable reliance on the performance of the contract, then *B* could fully protect himself against breach by incurring reliance expenses up to the difference between the contractual price and his reservation price for performance. In my example, *B* could guarantee that a breach by *A* would be efficient by incurring $15,000 in anticipation of moving into the house.

There is an efficiency problem in that, if reliance is the routine remedy, there seems to be little reason for *B* to stop at $15,000 in his expenses before *A* has performed. If he knows that the court will hold *A* liable for his reliance expenses, why should he not make $20,000 in pre-completion commitments? He may well have intended to make that commitment anyway in order, say, to have the house remodeled. The cost to him of re-timing that expenditure is small: the additional interest on the loan to effect the improvements. The result, however, is that the house may not now be efficiently allocated. *A* now faces a damage payment of $20,000 and may, therefore, perform when breach is more efficient. If *C* were willing to pay $118,000 for the house, then it should pass to him, since he values it more than does either *A* or *B*. But it will not if *A* is responsible to *B* for $20,000 in reliance damages.[58]

An answer to this objection to reliance damages as the routine remedy is that the law already discourages *B*'s over-reliance by protecting only *reasonable* reliance.[59] That is, the law will not allow *B* to pile on expenses willy-nilly so as to bind *A* to perform. There is no doubt from an efficiency standpoint that this is the proper stance for the law, but there are other reasons to believe that allowing only reasonable reliance will still not guarantee only efficient breach. The most important of these is that determining which reliance expenses

58. A more formal mathematical model of reliance and contract remedies is in Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466, 473-87 (1980).

59. RESTATEMENT (SECOND) OF CONTRACTS §§ 349, 350 (1979).

were reasonable and which were not is likely to be expensive. This is all the more true because the breachee has a strong incentive to demonstrate large reliance interest at the same time that the breacher has the contrary incentive to minimize that interest.

C. *Expectation*

The third interest of the innocent party that the law of contract damages protects is the expectation interest. Whereas with restitution and reliance the goal of the remedy is to place the innocent party in the position he was in before formation of the contract, with expectation damages the breachee is to be put in the position he expected to assume had the contract been performed.[60] The common law rule was enunciated in *Robinson v. Harman*:[61] "where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed." In addition to being the most widely used contract remedy, expectation has attracted the favorable attention of economists because it is the only measure of contract damages that induces breach only where breach is more efficient than is performance.

Consider again the contract between *A* and *B* for delivery of a house at a price of $100,000, a house that *B* values at $115,000. If it can be easily determined that *B*'s position under the completed contract will be a net gain of $15,000, then the expectation loss that *B* suffers from *A*'s nonperformance is precisely $15,000. If *A* is aware that that measure is the one that will be used if he breaches, then *A* will breach only when it is economically efficient to breach. Since *A* will be responsible to *B* for $15,000, he will breach only when *C* offers him more than $115,000 for his house. If *C* does make such an offer, then it may be concluded that the house is worth at least that much to *C* and that, therefore, he places a higher value on the house than does anyone else involved. Since our presumed goal for contract remedies is to move the house to its highest-valued use at the lowest cost, expectation damages seem to be the routine remedy for which we have been looking. Still, the law found it difficult until recently to justify expectancy as the routine contract remedy.[62]

While the theoretical attractiveness of expectation loss as a damage measure is straightforward, practical application of the measure is not.

60. RESTATEMENT (SECOND) OF CONTRACTS § 347 comment a (1979).

61. 154 Eng. Rep. 363, 365 (Ex. 1848).

62. Despite the fact that expectation damages was the routine remedy, the law did not offer persuasive reasons for it until very recently. See the articles by Birmingham, *supra* note 2.

The crucial problem is to determine, after the breach has occurred, what the innocent party's expected profit was at the time that the contract was formed. Clearly, the promisee has a powerful urge, after a breach, to exaggerate the gain he had expected from performance while the promisor has equally strong feelings that the gain could never have been so large. Recall that this is precisely the problem noted above with reliance damages.[63]

With regard to buyer's breach, the expectancy is lost profits. There are difficult measurement problems here, even though only reasonably foreseeable profits are recoverable. Not the least of these problems is that of determining whether the buyer's breach has, as with a unique good, or has not, as with a purely homogeneous good, resulted in the seller's having a lower quantity of sales.[64]

When one turns to consider measuring expectancy in the case of seller's breach, the problems are even more formidable.[65] The buyer is entitled to have his consumer's surplus protected by the law of remedies if we are to have only efficient seller's breach.[66] While this much is easy to agree upon, it is difficult to reach a consensus on how best to measure the buyer's subjective value of performance. In most cases, the best that the court can do is to guess at the relative magnitude of that surplus *vis-à-vis* the costs to the seller of completing the contract.[67] If it determines that the completion costs are too high relative to the subjective value to be protected, then the court will very likely use an objective standard, the diminution in the market value of the breachee's affected property, to determine his expectation interest.[68] There appear to be no distinguishing characteristics of cases in which cost of completion is superior to diminution in market value as the measure of the buyer's expectancy.[69]

---

63. It should be clear that in this situation the usual formation or performance defenses are not at issue. Thus, the economic consideration of which party was the cheaper insurer against the unexpected contingency that has frustrated the performance of the contract is not relevant.

64. *See* Goetz & Scott, *Measuring Sellers' Damages: The Lost-Profits Puzzle,* 31 STAN. L. REV. 323, 330-35, 346-48 (1979) (concluding that in a competitive market, lost-profit damages are inappropriate); *see also* Goldberg, *An Economic Analysis of the Lost-Volume Retail Seller,* 57 S. CAL. L. REV. 283, 292-93 (1984).

65. *See generally* Carroll, *Four Games and the Expectancy Theory,* 54 S. CAL. L. REV. 503 (1981) (urging the increased availability of specific performance, in large part because expectancy damages are likely to be under-compensatory).

66. In the house sale example above, *B*'s surplus of $15,000 was adequately protected only by expectation damages. *See* notes 60-62 *supra* and accompanying text.

67. The most notorious example of how wrong these guesses can be is Peevyhouse v. Garland Coal & Mining Co., 382 P.2d 109 (Okla.), *cert. denied,* 375 U.S. 906 (1963). For a discussion of this case see Linzer, *supra* note 11, at 134-38.

68. RESTATEMENT (SECOND) OF CONTRACTS §§ 272, 377 (1979).

69. For a survey of recent cases see Muris, *Cost of Completion or Diminution in Market Value: The Relevance of Subjective Value,* 12 J. LEGAL STUD. 379, 396-99 (1983). Professor

To alleviate these problems the common law has imposed some constraints on the expectancy of the innocent party:[70] the profits must have been reasonably foreseeable by the breaching party;[71] the profits must have been reasonably certain,[72] and the innocent party must have made good faith efforts to mitigate the damages.[73] Still, these guidelines do no more than make the measuring of expectation loss more tractable; by no means do these rules make it a simple matter.[74]

The common law's constraints on determining expectation loss from breach of contract may then be understood as an attempt to induce an efficient exchange of information at the time of contract formation on profits that will be foregone in the event of breach. Given that the parties are already in contact about so much of mutual interest, the costs of exchanging information about expected profits should be relatively low.[75] This goal is consistent with the goal of economic efficiency as applied to breach of contract in that it places a large part of the burden of determining expectancy at contract formation time on those who can most cheaply assess it, the contractual parties, and relieves the court of the burden of making this determination only after a breach.

The recent literature on damages as a contract remedy has confirmed the superiority, from an efficiency standpoint, of expectation over other damage measures. Professor Shavell has recently shown, in an elegant model of the decision to perform or to breach, that, although no damage measure can act as a perfect substitute for a complete contingent contract,[76] the expectation measure is generally

Muris argues that no blanket rule is appropriate; rather, the courts must protect the buyer's subjective valuation by determining, apparently on a case-by-case basis, the cheaper form of expectation damages. *Id.* at 395-96.

70. 22 AM. JUR. 2D *Damages* § 46 (1965).

71. Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854); Evra Corp. v. Swiss Bank Corp., 673 F.2d 951 (7th Cir. 1982), *noted in* 71 ILL. B.J. 506 (1983).

72. Freund v. Washington Square Press, 357 N.Y.S.2d 857, 314 N.E.2d 419 (1974); Griffen v. Colver, 16 N.Y. 489, 491 (1858).

73. RESTATEMENT (SECOND) OF CONTRACTS § 350 (1979); U.C.C. §§ 2-703, 2-704, 2-706, 2-711, 2-712 (1977); Farnsworth, *supra* note 48, at 1158.

74. These guidelines, while making dispute resolution more efficient, also lessen the tendency to promote only efficient breaches because *A* is less likely to be forced to make *B* as well off as he had expected to be upon completion of the promise.

75. There might be some reluctance, however, on the part of the parties to give expected profit information because it increases the other party's bargaining strength. If one party knows in advance that the other party will make a profit of $10,000 under one set of terms, he might negotiate for terms that give him more profit.

76. A complete contingent contract would include provisions for dealing with every conceivable future contingency. Certainly the costs of this sort of specification are prohibitive. It seems far more sensible to believe that contractual parties specify contingencies up to the point at which the cost of specifying what should be done in the event of one more contingency is equal to the expected benefit from allocating responsibility for loss in the event of that contingency.

Pareto-superior to any other in promoting only efficient breach.[77]

These models ignore, however, the possibility of recontracting or renegotiating after formation and after the seller's announcement of his intention to breach. If the costs of renegotiation are not too high, some of the remedies considered may be more efficient than others at inducing the parties to use recontracting rather than some less efficient alternative, like litigation, to allocate the losses from breach.

Professor Rogerson has considered the situation when renegotiation is possible.[78] He compares the abilities of reliance damages, expectation damages, and specific performance, given the possibility of post-breach negotiations, to minimize deviations from an optimal level of reliance. An interesting additional consideration is whether different negotiating abilities affect the outcome under different remedies. He concludes that at any level of relative negotiating strength, the inefficiency from reliance damages is greater than that from expectation damages[79] and that specific performance "always generates at least as efficient an outcome as expectation damages. Furthermore, for all levels of negotiating strength, "specific performance Pareto-dominates expectation damages and reliance damages."[80]

The conclusion of the literature on the efficiency goal in damage measures for breach of contract may be briefly stated: the expectation interest is the only measure of damages that will lead to efficient breach. There are, nonetheless, some widely recognized problems that arise in the measurement of the breachee's expectation interest. In the case of buyer's breach, the seller's reasonably foreseeable profits from the completed contract should be taken as the measure of damages if the goal is to encourage only efficient breach. Yet there are well known pitfalls in computing lost profits. In the case of seller's breach, the buyer's expectation interest is his consumer surplus or subjective valuation of the completed contract. There are serious evidentiary problems in determining this amount. It is probably the case that stipulated damages, if enforced even with a seemingly punitive element, are a less costly way to protect subjective valuation than are expecta-

77. Shavell, *supra* note 58, at 485. For an analysis of the efficiency of other aspects of contracts, see Diamond & Maskin, *An Equilibrium Analysis of Search and Breach of Contract, I: Steady States,* 10 BELL J. ECON. 282 (1979) (impact on efficient damage measures of assuming a costly stochastic search process for contractual partners); Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract,* 66 VA. L. REV. 1443 (1980) (questioning the efficiency aspects of the strict compensation principle); Polinsky, *supra* note 31 (ability of contract remedy to allocate risk optimally).

78. Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract,* Working Paper No. 8 (Apr. 1983), Law & Economics Workshop Series, Stanford University Law School.

79. *Id.* at 5.

80. *Id.* at 6.

tion damages. It is as yet an open question whether the inefficiencies of the alternative legal remedies, restitution and reliance, are severe enough to offset the far greater ease and precision of measuring those alternatives to expectation. We have yet to discuss whether expectation, with its high costs of measurement, is a superior guarantor of only efficient breach than is the equitable remedy, specific performance. I turn to that discussion in the next section.

IV. THE EFFICIENCY OF SPECIFIC PERFORMANCE

Damage payments are the legal remedy for contract breach; specific performance is the equitable remedy.[81] Specific performance is a judicial order requiring the promisor to perform his contractual promise or forbidding him from performing the promise with any other party.[82] If, for example, *A* has promised to sell a house to *B* for $100,000 but breaches in order to sell to *C* for $125,000, *B* might seek relief in the form of a court order requiring *A* to sell to *B*. Alternatively, *B* might ask the court for an injunction forbidding *A* to sell to anyone but *B*. As a general rule, the court invokes equitable remedies only when it thinks that legal remedies are likely to offer inadequate relief, that is, to be under-compensatory.[83] The granting of equitable relief is at the discretion of the court upon a demonstration by the plaintiff that damages will not adequately compensate him. The typical cases in which this under-compensation is said to arise are in the sale of "unique goods,"[84] the sale of land (considered by the law, largely for historical reasons, to be a unique good),[85] and long-term

81. J. DAWSON & W. HARVEY, CONTRACTS 132-37 (3d ed. 1977).

82. *See* BLACK'S LAW DICTIONARY 1024 (5th ed. 1979).

83. RESTATEMENT (SECOND) OF CONTRACTS § 359(1), comment a (1979); *see also* U.C.C. § 2-716 (1977). An exhaustive list of contracts that courts are likely to enforce by specific performance is given in 5A A. CORBIN, CONTRACTS, §§ 1143-1155 (1964). Among those identified are the following: contracts for the sale of standing timber; contracts for the sale of land or for the sale of other unique goods; contracts requiring performance in installments, for example, alimony and an insurance company's promise to pay benefits in installments; contracts for the sale of corporate shares, if the shares cannot be obtained in the market and the plaintiff's damages cannot be ascertained; contracts to lend money, but only if the promisee has materially changed his position since formation, made new contracts, and already transferred all his land to give security; contracts for the benefit of a third person; and contracts by a trustee, owing to the historical fact that trusts were created by courts of equity and long remained out of the reach of courts of common law. Corbin also enumerates the types of contracts in which courts will generally refuse to grant specific performance, even if remedies at law are inadequate. *Id.* §§ 1162-1176. These include cases of contract frustration due to impossibility, fraud, unilateral mistake, and the like.

84. U.C.C. § 2-716 (1) (1977) ("[s]pecific performance may be decreed where the goods are unique or in other proper circumstances").

85. A. CASNER & W. LEACH, CASES AND TEXT ON PROPERTY 725 (3d ed. 1984); Farnsworth, *supra* note 48, at 1154. *But cf.* UNIF. LAND TRANSACTIONS ACT § 2-506(b), 13 U.L.A.

input contracts.[86] When an otherwise innocent party asks for specific performance, the breacher is permitted to mount defenses that are not usually available against a damage award: insufficient certainty of terms, inadequate security for the innocent party's performance, the breacher's unilateral mistake, and the high level of supervisory costs that the court might incur in enforcing performance.[87]

The economic efficiency of this state of affairs is open to question. In particular, it is not obvious that the efficient exchange of reciprocal promises or the enforcement of valid contractual promises is best served where specific performance is reserved for the circumstances noted above. Indeed, we have already seen that some scholars have suggested that specific performance is generally more efficient than other contract remedies.[88] In this section, I shall attempt to show that specific performance should be, on efficiency grounds, the routine contract remedy.[89] The reasons for this conclusion may be briefly summarized here. First, if contractual parties are on notice that valid promises will be specifically enforced, they will more efficiently exchange reciprocal promises at formation time. In particular, they will have a stronger incentive than currently exists under the dominant legal remedy to allocate efficiently the risks of loss from breach rather than leaving that task, in whole or in part, to the court or to post-breach negotiations conducted under the threat of a potentially inefficient legal remedy. Second, and perhaps most importantly, specific performance offers the most efficient mechanism for protecting subjective values attached to performance. Thus, it promotes contract breach only if it is efficient, that is, if someone will be better off and no one will be worse off because of the breach. In this regard, specific performance and an expansive enforcement of stipulated remedies constitute integral and inseparable parts of a unified theory of efficient contract remedies. Third, if specific performance were the routine remedy, the post-breach costs of adjusting a contract in order to move

633-64 (1977) (rejecting the notion that a seller of real property is automatically entitled to specific performance).

86. Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts,* 76 Nw. U. L. REV. 369, 390-92 (1981); U.C.C. § 2-716, comment 2 (1977).

87. RESTATEMENT (SECOND) OF CONTRACTS §§ 362 comment a, 363, 364, 366 (1979). Thus while legal remedies for breach of contracts for labor and other professional services would typically result in under-compensation, courts will generally refuse to grant specific performance as a remedy. RESTATEMENT (SECOND) OF CONTRACTS § 367(1) (1979) states that specific performance of a promise of a personal, *i.e.,* a nondelegable, service will not be decreed. *See also id.* § 361 illustrations 1 & 2, regarding duties to forbear, specifically not to compete.

88. *See* text at notes 78-80 *supra.*

89. Schwartz, *supra* note 6, reached the same conclusion for reasons related to, but distinguishable, from mine.

the promise to the highest-valuing user would be lower than under the most efficient legal remedy. The central reason for this is that under specific performance the costs of determining various parties' valuation of performance are borne by those parties in voluntary negotiations. This means that the costs of determining willingness-to-pay are borne by those most efficiently placed to determine that amount. Finally, because the costs of ascertaining any subjective values of the innocent party through evidence presented to a court are so high and because, therefore, the possibility of undercompensating the innocent party through a damage remedy is high, specific performance is far less likely to be undercompensatory and far more likely to protect the breachee's subjective valuation than is any other judicially imposed contract remedy.

A. *The Role of Transaction Costs in Determining Contract Remedies*

To begin the development of an integrated theory of legal and equitable remedies for breach of contract, it is appropriate to review a proposed approach to choice of remedies in a different area of the law. Professors Calabresi and Melamed have offered an integrated theory of remedies designed to promote efficient resource use in resolving incompatible property uses, that is, in circumstances where there are externalities.[90] Assume that society has already allocated the rights, which Calabresi and Melamed call entitlements, to various scarce resources, and further assume that the assignment has been conducted so as to lead to the most efficient use of society's scarce resources. This having been done, society must next determine what institutions, including rules of law, will most efficiently protect those entitlements. Calabresi and Melamed suggest that, where feasible, the constraints imposed by voluntary exchange offer the best method of both protecting entitlements and of directing them to their highest valued use. The court may assign an entitlement and then, through the granting of injunctive relief, instruct the parties in conflict to use the method of voluntary exchange to protect that assignment.[91] An injunction, in this

90. Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral,* 85 HARV. L. REV. 1089 (1972). Later articles commenting on various aspects of this seminal article are Frech, *The Extended Coase Theorem and Long Run Equilibrium: The Nonequivalence of Liability Rules and Property Rights,* 17 ECON. INQUIRY 254 (1979); Polinsky, *Controlling Externalities and Protecting Entitlements: Property Rights Liability Rules and Tax-Subsidy Approaches,* 8 J. LEGAL STUD. 1 (1979); and Polinsky, *On the Choice Between Property Rules and Liability Rules,* 18 ECON. INQUIRY 233 (1980).

91. Calabresi & Melamed, *supra* note 90, at 1105-10. The injunction in this model should be understood to cover both a negative injunction forbidding the defendant from doing something and a mandatory injunction requiring him to do something affirmatively. How a conditional

framework, is to be understood as a declaration that the prices arrived at by bargaining in voluntary exchange are the best guide to determining which of the conflicting uses is more efficient.[92] This method of protecting entitlements — a method that the authors call one of property rules — is the most efficient means when the level of transaction costs between the parties in conflict is low. Only in those circumstances is it possible for voluntary exchange to determine which of the competing uses is of higher value.

The market cannot make this determination, however, when the transaction costs between parties in dispute are high.[93] When voluntary exchange is incapable of resolving disputes about which of two conflicting uses of entitlements is more valuable, Calabresi and Melamed propose using judicially supervised exchange to protect and, possibly, reallocate resources.[94] This is the method of assessing money damages. Leaving aside the very complicated problems of how to determine the level of damages, we may understand, following Calabresi and Melamed, legal relief as being a determination by the court of an objective price at which the entitlement in dispute would have changed hands had transaction costs been very low. This hypothetical market analysis — a method that Calabresi and Melamed call protection of an entitlement by a liability rule — is the most efficient way of determining the most valuable use of an entitlement over which there is a conflict if the transaction costs between the parties are high.[95]

Let us briefly consider an example. Suppose that a factory begins to create a great deal of air pollution, causing harm to the property and health of the many residents who live nearby. Let us use the Calabresi and Melamed framework to analyze what method most efficiently protects the rights assignment, whatever that assignment may be. Suppose that the residents have an entitlement to be free from

injunction might fit into the Calabresi and Melamed framework is not entirely clear. *See* Rabin, *Nuisance Law: Rethinking Fundamental Assumptions*, 63 VA. L. REV. 1299, 1300-01 (1977). The Calabresi and Melamed property rule should also be interpreted to cover the case in which the court summarily dismisses the complaint; in those circumstances, the court may be said to have given the entitlement to the defendant and to have protected that assignment through a property rule in that, thereafter, the plaintiff's only means of gaining access to the entitlement is to purchase it from the defendant.

92. R. POSNER, *supra* note 1, at 48-52.

93. Calabresi & Melamed, *supra* note 90, at 1101. See text at notes 130-33 *infra* for a discussion of the situations in which transaction costs are likely to be high.

94. *Id.* at 1125.

95. *Id.* at 1119-24. They also suggest that there may be circumstances in which society most efficiently protects entitlements by forbidding their exchange in either the market or through objective determination of value by a court. Although the issue of when a rule of inalienability is most likely to be the most efficient rule is important and interesting, it plays no role in the analysis of contractual remedies and will, therefore, not be discussed here. *Id.* at 1111-15.

harm from the factory's pollution. When they bring an action seeking relief from the harm, should the court protect their entitlement by granting injunctive relief against the factory or should the court assess money damages against the factory? The correct answer is probably that the entitlement is most efficiently protected by assessing money damages against the polluter. This is because the large number of parties involved is likely to make the transaction costs between the residents and the factory so high as to make any voluntary exchange of the entitlement impossible. Thus, an injunction against the factory might create inefficiencies.

If the factory valued the right to pollute more than the residents collectively valued the right to be free from pollution but if transaction costs between the two groups were high, it would prove impossible for the factory to purchase the right not to enforce the injunction away from the residents in whose favor it ran. Consider the costs to the factory of locating all those adversely affected by its pollution; of bargaining with each of them about the price he is willing to accept to waive his right to be free from the pollution; and the costs to the factory and the residents of monitoring and enforcing the multi-party bargains. All of those costs are likely to be so high as to frustrate any voluntary exchange between the parties to the dispute. In addition, there is the special problem in this hypothetical situation of one of the residents holding out at the end: that is, waiting until his consent is the last one required for the bargain to be struck and then refusing to sell his right except for a monopoly price. Since the hold-out position is so valuable, there is every reason to believe that many residents will attempt to be the hold-out by balking at reaching any voluntary agreement with the factory. The holdout problem further increases the costs of reallocating the entitlement to its highest valued use.[96] In these circumstances, society should attempt through the court to take evidence on who values the entitlement more and then, through the court's determination of money damages, offer a collective valuation of the entitlement. That valuation would be the price at which society would allow the entitlement to change hands.[97]

96. On the hold-out problem and the closely associated free rider problem, see H. KOHLER, *supra* note 3, at 559-60. The free-rider problem would have arisen in the situation described above if the court had chosen to protect that right by a property rule. Then, if the residents valued the right to be free from pollution more than the factory valued its right to pollute, the costs to the residents of purchasing that right from the factory would have been significantly raised by many residents' desire to let others bear all the costs of negotiating and concluding an exchange with the factory in the hope that they could then enjoy the benefits of a reduction in pollution without having to incur the costs of affecting the exchange. These residents would have taken a free ride on the efforts of their neighbors to purchase the right.

97. Of course, this does not mean that the level of money damages must be set in such a way

The Calabresi-Melamed framework has a ready application to the question of efficient remedies for breach of contract. Damages and specific performance, like damages and injunctive relief in nuisance law, should be seen as alternative means of achieving efficient resource allocation in the face of different transaction costs. When a contract has been breached, the question of utmost importance to the court should be the level of transaction costs facing the defaulter and innocent party. If those costs are low, then private negotiations are possible and the most efficient relief for the court to order is specific performance. If, however, transaction costs are high, then the court should compel an exchange at a collectively determined value; that is, it should assess money damages against the breacher.

In general, the post-breach transaction costs between contractual parties should not be high. After all, they have established a relationship before the breach and the things that make for high transaction costs in other legal contexts are entirely absent here: the parties have identified each other; they have bargained to provide for many contingencies — including, possibly, breach; they may have had contact after formation and before full performance to clarify details, report progress, and the like. Thus, if the parties did not provide for some form of relief in the event of breach, the costs to them of dealing with the contingency that has arisen to frustrate the contract should be low. This is a strong *prima facie* reason for making specific performance, rather than damages, the routine contract remedy.

Certainly, the costs to the parties of resolving their dispute, for example, of determining what the innocent party's expectation interest is, would seem to be lower than they would be for a court. This is because the court, in order to resolve the dispute efficiently and to create an efficient rule to guide future contracting parties, would have to inform itself about all the relevant terms of the contract, the market for the commodity involved, the believability of each party's evidence on its expectancy, the reasonableness of the risks assumed, and so on. This is a burdensome and expensive duty for the court to take on. If instead the courts routinely award specific performance, future parties may be induced to stipulate their own remedies if it is efficient for

as to allow the factory to purchase the right to pollute from the residents. The damages should be set in such a way that they approximate the price at which the residents would have willingly sold this right, if transaction costs had been low. If the level of damages has been correctly determined and is such that at that price it would not have been worth it to the factory to continue in operation, then the factory closes down and liquidates in order to discharge the residents' claims. This result is, by definition, the efficient result if the level of damages has been correctly determined. At any other price, the factory may pay the damages and continue in operation.

them to do so; otherwise, they will bargain in the understanding that specific performance will be enforced in the event of breach. It follows that only efficient breach will then occur.

To see what this means, let us reconsider the example with which we have already discussed the efficiency aspects of various legal remedies. Recall that *A* has contracted to sell a house to *B* for $100,000. Before the promise is completed, *C* offers *A* $125,000, and *A* breaches his contract with *B* in order to sell to *C*. Suppose now that when *B* sues *A*, the court awards *B* specific performance rather than damages. This does not mean that the house cannot end up with *C*, who is the person to whom wealth-maximizing or efficiency considerations urge us to direct the asset. Indeed, under specific performance the house can pass to *C* in several ways. *A* might purchase the right to specific performance from *B* and then sell to *C*. Or *B* might refuse to release *A*, take possession, and then sell to *C*.

In both of these cases, the house eventually passes to *C*, who, by assumption, values it more than does either *A* or *B*. What distinguishes the cases is the distribution of the gain from that breach. Where the remedy is specific performance, private negotiations after the innocent party has been assigned the entitlement to performance are the mechanism for dividing the gain. The important fact is that under specific performance the house will pass to the party who values it the most, regardless of how negotiations between the breacher and the innocent party apportion the surplus from breaching and selling to *C*.[98] From an efficiency standpoint the allocation of this increase in value between breacher and innocent party is of secondary interest.

To summarize, the level of transaction costs should guide the court in fashioning efficient contract remedies. Where those costs are low, the court should award specific performance; where they are high, money damages. Since, in general, the transaction costs between contractual parties are low once a contract is formed, the routine remedy for breach should be specific performance. This will place the burden of resolving the breach on the contractual parties, whose costs of doing so are lower than those of the court. The costs of dividing any surplus to be realized from efficiently breaching the contract will be borne by the breacher and the breachee, not by the court. This, too, is an efficient result. Combined with the fact that only efficient breach will occur if specific performance is the routine remedy, specific performance is the only contract remedy that is efficient on both levels: en-

98. The only caveat to this statement has to do with the effects of strategic behavior in the post-breach negotiations. *See* text at notes 132-35 *infra*.

couraging only efficient breach and efficiently resolving any breach that occurs.

B. *The Effect of Specific Performance on Formation (Pre-Breach) Negotiation Costs*

One of the claims I have made for specific performance is that it will induce parties to exchange promises more efficiently. There are two important issues here: first, is it possible that the law's current restrictions on the availability of specific performance correspond to the choice between specific performance and money damages to which contractual parties would stipulate if they were perfectly free to do so, and second, would specific performance cause contracting parties to expend resources inefficiently at formation time?[99] If the answer to either question is yes, then there is reason to doubt the superior efficiency of specific performance as the routine contract remedy. However, as we shall see, neither of these questions may be answered affirmatively. The conclusion I draw is that specific performance, especially when combined with the more liberal attitude urged above for interpreting liquidated damages, will, in general, *lower* contract formation costs.

1. *The Relationship of Current Specific Performance Rules to Stipulations in Voluntary Exchanges*

Let us begin by seeing whether it might not be the case that the law's current rules for awarding specific performance and money damages correspond to what freely contracting parties would choose to stipulate as their contractual relief in the event of breach. The importance of the inquiry is this: if current remedies correspond to what voluntary exchange would stipulate at formation time as the wealth-maximizing remedies, then that constitutes strong evidence that the current law of contract remedies is efficient.

In an important article Professor Kronman has suggested that, judged on an efficiency standard, specific performance is currently being correctly invoked.[100] The heart of the argument is that, in a contract for the sale of a unique good, promisor and promisee would agree, if the court would recognize their agreement, that the promisor should perform specifically. By the same token, in a contract for the sale of a fungible good, promisor and promisee would agree that

99. Or, more accurately, would specific performance cause parties to expend resources more inefficiently than they would do with money damages as the routine remedy?

100. Kronman, *supra* note 6, at 363-65.

money damages would be paid to the promisee in the event of the promisor's breach. Central to Professor Kronman's thesis that damages and specific performance are currently being efficiently applied as contract remedies is the cost to the court of determining the value of a substitute good:

> In asserting that the subject matter of a particular contract is unique and has no established market value, a court is really saying that it cannot obtain, at reasonable cost, enough information about substitutes to permit it to calculate an award of money damages without imposing an unacceptably high risk of undercompensation on the injured promisee. Conceived in this way, the uniqueness test seems economically sound.[101]

A crucial tenet of this argument is that money damages in the case of unique goods are likely to be under-compensatory and will, therefore, lead to inefficient breach. Thus, it is important to be clear about the sources of this under-compensation.

The costs incurred in pre-contract search — those of locating sellers, obtaining information, comparing quality, and so on — are not generally recoverable if the contract is breached.[102] In this respect what distinguishes fungible from unique goods is that, despite the breach, pre-contract search costs will bear fruit in the case of fungible goods but not in the case of unique goods. Therefore, money damages are likely to be under-compensatory in the case of unique goods.[103]

Professor Kronman asserts that there is a second sense in which the application of the two types of contract remedies conforms to the goal of efficiency. The uniqueness test

> draws the line between specific performance and money damages in the way that most contracting parties would draw it were they free to make their own rules concerning remedies for breach and had they deliberated about the matter at the time of contracting. . . . [t]he uniqueness test promotes efficiency by reducing the costs of negotiating contracts.[104]

The argument is that at the contract formation stage promisor and promisee would agree to judicially enforceable damages or specific performance remedies in precisely the circumstances in which courts currently apply those alternatives. Let us examine the two possibilties, unique and fungible goods, in turn.

When the contract covers unique goods, the promisee will prefer the remedy of specific performance to damages, under which he is likely to be under-compensated in the event of breach. The promisor will always prefer damages to specific performance, regardless of

---

101. *Id.* at 362.

102. 5 A. CORBIN, CONTRACTS § 1034 (1964)

103. Kronman, *supra* note 6, at 364.

104. *Id.* at 365.

whether the good is unique.[105] The promisor must therefore be enticed to opt for a clause in favor of his specific performance by the promisee's offer to pay a contract price that is greater than he would pay if he only wanted money damages. Professor Kronman argues that promisors of unique goods, facing a thin market, will be more willing to accept a provision for specific performance than would be the case with fungible goods because the chances of his receiving a more attractive third-party offer are not very high.[106] For nonunique goods and services, the promisor is more likely to receive alternative offers before he has fulfilled his contractual promise and is, therefore, more adamant about retaining the flexibility that comes with a money damages rule. In short, Kronman concludes that the circumstances in which courts now routinely apply money damages and specific performance are the same circumstances in which efficiency dictates those remedies. Moreover, private negotiations between parties at the time of contract formation covering remedies in case of breach would also conform to the current judicial guidelines for legal versus equitable relief.

There is a sense in which this conclusion is perfectly correct and yet not as forceful as it at first may seem, and there is another sense in which Professor Kronman's conclusion is incorrect. Before discussing what may be correct about this hypothesis, let me point out where it goes awry. First, the contention that equitable relief is reserved in the law only for contracts involving unique goods is not correct. Specific performance has been applied by the courts to numerous circumstances in which "uniqueness" of goods or services is not obvious. The most often cited unique contracts are those for the conveyance of land, and yet, economically speaking, there is nothing unique about parcels of realty.[107] In fact, in most circumstances substitutes abound. Another location at a slightly different price is just as good. It is a differ-

105. This is so because the promisor will only breach if he is better off by breaching, *i.e.*, someone offers him more money. If he need only pay damages, he can keep all of the additional money himself unless the promisee can overcome problems of proof of expectation greater than contract costs. If, however, specific performance is the remedy, the seller must use that additional money to buy the buyer's right to specific performance.

106. Kronman, *supra* note 6, at 368-69.

107. *See* 71 AM. JUR. 2D *Specific Performance* § 112 (1973):

> The subject matter most commonly involved in actions for specific performance is that of contracts for the sale of land or contracts which otherwise involve interests in real estate. The reason for this lies . . . in the fact that the remedy at law is less likely to be adequate in the case of land than in the case of other property . . . The most important aspect of land, insofar as equity jurisdiction for specific performance is concerned, is that no piece of land has its counterpart anywhere else, and is impossible of duplication by the expenditure of any amount of money.

Footnote omitted. *See also* Dickinson v. McKenzie, 197 Ark. 746, 126 S.W.2d 95 (1939); McVoy v. Baumann, 93 N.J. Eq. 638, 117 A. 725 (1922).

ent thing altogether to assert that a particular individual considers a particular piece of land unique. In that case, the issue is not so much uniqueness as it is some contractual party's subjective valuation, the issue that, as we shall see, is at the heart of the issue of the most appropriate general contract remedy. Similarly, agreements by the seller of a business not to compete with the buyer are routinely enforced by specific performance.[108] In various jurisdictions equitable relief for breach of contract has been ordered for such wide-ranging agreements as the following: the sale of a franchised bottled-gas business,[109] a contract for the support of an illegitimate child,[110] and an advertisement.[111] A survey of actions for specific performance of sales of corporate stock between 1953 and 1961 found that most of those contracts were specifically enforced.[112] Requirements contracts — those to buy and sell all of a given commodity that the buyer may need or require in his business during a specified, usually long, period — are frequently specifically enforced where the plaintiff seeks that remedy.[113] Some states have statutorily liberalized the granting of relief through specific performance.[114]

Finally, Professor Corbin has written:

> A reading of many modern cases will make clear the fact that the question of adequacy of other remedies is very frequently not even referred to in the opinion of the appellate court. They do not take the trouble to explain why such remedies are not adequate for complete justice, even though their inadequacy does not clearly appear from the reported facts. . . . [T]he impression plainly left by the sum-total of reported cases is that the remedy of specific enforcement is as available as are other remedies, now that in almost all jurisdictions all remedies are to be sought in a single system of courts and no longer in separate and mutually suspicious courts of common law and courts of chancery. Objections on the ground of inadequacy of money damages are less often made than formerly and are given less consideration by the judges. Of

---

108. *See, e.g.*, Stokes v. Moore, 262 Ala. 59, 77 So. 2d 331 (1955); Diamond Match Co. v. Roeber, 106 N.Y. 473, 13 N.E. 419 (1887); Mitchell v. Reynolds, 24 Eng. Rep. 347 (Ch. 1711). *See generally* Goldschmid, *Anti-trust's Neglected Stepchild: A Proposal For Dealing With Restrictive Covenants Under Federal Law*, 73 COLUM. L. REV. 1193 (1973).

109. Hogan v. Norfleet, 113 So. 2d 437 (Fla. Dist. Ct. App. 1959).

110. 10 AM. JUR. 2D *Bastards* § 73.

111. Goddard v. American Queen, Inc., 44 A.D. 454, 61 N.Y.S. 133 (1899).

112. Van Hecke, *Changing Emphases in Specific Performance*, 40 N.C. L. REV. 1, 1-3 (1961).

113. *See* Farnsworth, *supra* note 48, at 1155; Speidel, *supra* note 86; Van Hecke, *supra* note 112, at 7-8.

114. *See, e.g.*, MD. ANN. CODE art. 16, § 169 (1981); MASS. ANN. LAWS ch. 214, § 1A (Michie/Law. Co-op. 1955). The change was recommended by the Massachusetts Judicial Council, which apparently felt that in a heavily regulated economy, money damages were no longer equivalent to performance. For a discussion of these states' approaches, see Van Hecke, *supra* note 112, at 9-11.

course, a defendant who wishes a jury trial will be more insistent on the adequacy of the common law remedy.[115]

It is worth noting that in the civil law countries specific performance is the routine contract remedy.[116] This is a difficult situation to understand if there is really something to Professor Kronman's contention that confining equitable relief to the case of unique goods corresponds to what freely contracting parties would prefer. Perhaps the tastes of contracting parties in Western Europe are vastly different from those in the common law countries, but this is very doubtful. More likely, there is no necessary connection between specific performance and uniqueness.[117]

While it would be too much to maintain that these observations represent an exhaustive sample of the instances in which specific performance has been or will be granted, they strongly suggest that the instances in which the court will award equitable relief rather than damages is by no means limited to the instances of uniqueness adduced by Professor Kronman.[118]

All this having been said, it is nonetheless the case that there is an important germ of truth in Professor Kronman's hypothesis. I believe that his contention would be completely accurate if it were revised to read as follows: If contracting parties were free to specify *any* remedy that was mutually agreeable, they would be likely to opt for specific performance rather than damages where the promisee attached some particular *subjective valuation* to the promisor's performance. The key difference here is the insertion that it is subjective valuation rather than uniqueness that makes specific performance attractive. Clearly, there is a relationship between uniqueness and subjective valuation: someone is more likely to attach a value greater than market value to a rare, one-of-a-kind item than to a highly fungible item. However, the class of things to which someone attaches a subjective valuation is

115. 5A A. CORBIN, CONTRACTS § 1142, at 125-26 (1951).

116. *See* A. VON MEHREN & J. GORDLEY, THE CIVIL LAW SYSTEM 1108-21 (2d ed. 1977); Dawson, *Specific Performance in French and German Law*, 57 MICH. L. REV. 495, 524 (France), 529-30 (Germany) (1959). Specific performance is also the routine remedy in most Communist countries, probably because markets in which the breachee may make a covering transaction are not readily available. *See* Grossfeld, *Money Sanctions for Breach of Contract in a Communist Economy*, 72 YALE L.J. 1326, 1330-31 (1963)

117. Alternatively, it may be argued that specific performance is not, in practice, the routine contract remedy in civil law countries. Some scholars note a trend toward convergence in contract remedies in the civil and common law countries. *See* A. VON MEHREN & J. GORDLEY, *supra* note 116, at 1122-23. There is, however, a dearth of empirical evidence on this point.

118. The fact that we do not have empirical analyses of the percentage of contract disputes resolved through damages and through specific performance is a measure of how far we have to go in making positive analysis of the law. Nor do we know for certain how, if at all, those percentages have varied over time. With the computerization of case reporting, the cost of making such analyses may have fallen far enough to make them feasible.

greater than the class of unique items. Once his category is expanded to include all promises to which there is a subjective valuation, then the rest of Professor Kronman's analysis stands.

Of course, it is not now the case that contracting parties may specify any contractual remedy. As we have seen,[119] they may not stipulate damages in excess of reasonably anticipated expectation damages, nor may they agree to be specifically bound.[120] Absent these restrictions, contracting parties would stipulate remedies that, at the most reasonable cost, adequately protected the value they anticipated from completion of the contract. If the least expensive manner of doing that is for the promisor to agree to be specifically bound, then presumably that is what will be stipulated in the contract. It is possible, however, to imagine a circumstance in which the parties would agree to a stipulated *money damages* remedy, in excess of actual damages, as the least cost method of protecting a subjective value. This might occur where there is reason to believe that the most likely frustrating contingency would make performance physically impossible, a circumstance for which specific performance would provide no salve at all.[121] In the case of fully fungible goods, contracting parties would no doubt be willing to leave their stipulations as to remedies at expectation damages.

2. *Contract Formation Costs with Specific Performance Available as a Stipulated Remedy and as the Routine Court-Imposed Remedy*

Almost no attention has been paid to the effect that specific performance as the routine remedy would have on contract formation costs. There are three possibilities: formation costs can rise, be unaffected, or fall, as compared to formation costs under money damages as the routine remedy. For those performances to which the promisee attaches a subjective valuation the formation costs under specific performance would probably decrease. This is because the wider availability of the equitable remedy would relieve the parties of the costs of contracting around the law's unwillingness to enforce either a punitive-seeming liquidated damage clause or an agreement to perform

119. *See* notes 27-29 *supra* and accompanying text.

120. *See* text at note 45 *supra.*

121. It is an interesting question whether the unavailability of stipulated damages in excess of actual damages and of stipulated specific performance have made the costs of exchanging promises to which one party attaches a subjective valuation inefficiently high. Because there is still some gain to be had from exchanging these promises, parties may have been forced to contract around the law's reluctance to allow them to protect their subjective valuation at contract formation time.

specifically. A party who wants his subjective valuation protected must currently find alternative methods of insuring against that frustration. He must, for example, find someone other than the other contracting party to underwrite his subjective value on performance. This happens even in circumstances, as we have seen, in which the promisor is probably the cheapest provider of that insurance.[122] The promisee might offer to pay the promisor a performance bonus, but its specification is costly and the enforceability of that provision is itself in some doubt.

It might be argued that even if the contract formation costs of those seeking to protect subjective valuation would be reduced by the routine availability of specific performance, the costs for those contracting for the sale of fungible goods would be raised. This would be the case if the parties had to undertake some formation expenses not currently incurred in order to avoid specific performance. The worst that can be envisioned is that the sale of a purely homogeneous product would become more expensive because the parties would be obliged to include a stipulation as to damages.

While it is perhaps true that making specific performance the routine contract remedy would increase the cost of contracting for the sale of fungible goods, there is a sound economic reason for not being much concerned about this increase: the increase is not likely to be large. There can be little doubt that for pure homogeneous goods boilerplate stipulations would become even more routine than they currently are, and if the courts continue to enforce stipulated remedies that do not exceed reasonably anticipated damages, then there would be no question about the enforceability of these stipulations. Even when the homogeneity of the contractual good is not pure, that is, when there is some product differentiation, the costs to the parties of contracting around specific performance, if that is what they prefer to do, are not likely to be large. As one passes along the spectrum from purely homogeneous to more unique goods, the costs of contracting out of specific performance as the routine remedy increase. Note, however, that as the uniqueness of the contractual performance increases, it becomes increasingly likely that the promisee will be willing to let the routine remedy of specific performance protect his expectation interests. Thus, the cost increase is likely to affect a small subset of those forming contracts, and, even for that limited class, boilerplate stipulations are likely to make the cost increases trivial.

This may seem a curious argument: above it was asserted that one

122. *See* note 32 *supra* and accompanying text.

of the inefficiencies of not allowing specific performance as the routine remedy was that it forced those parties who wished to protect their subjective valuation to expend resources inefficiently in contracting; here, it is being asserted that if additional formation costs are inflicted on those who wish to contract around specific performance, that is efficient. Why is this increase in costs excusable in the one case as efficient and inexcusable in the other as inefficient? The only answer, absent empirical confirmation, is that the increase in contract formation costs to those who desire not to be specifically bound to their contractual promise are less than those currently inflicted on those who desire, but are unable to get, specific performance.

Another group whose costs of contracting may be increased by the routinization of specific performance are those who would prefer stipulated money damages sufficient to protect their subjective valuation. It is hard, however, to see how they would be worse off under specific performance than under the regime of money damages. Let us assume for the moment that courts continue not to enforce liquidated remedies that contain a seeming *in terrorem* clause. The best that this group can do under current contract remedies is to contract around these restrictions or, if a breach occurs, to persuade the court of the inadequacy of money damages. Both of those alternatives are expensive. If specific performance becomes widely available, the costs to this group of protecting their subjective valuations will be reduced, but not minimized.[123] So, although the routinization of specific performance is not the best of all possible worlds for all of those with a subjective valuation to protect, it is better than a system in which money damages are the routine remedy.

In summary, we may predict that contract formation costs would not on the whole be significantly changed by making specific performance the routine contract remedy. For those who place a subjective valuation on performance, specific performance would reduce formation costs by relieving them of the high costs of contracting around the inadequacy of money damages or of demonstrating at trial the inadequacy of money damages. For those who, in the most efficient of all possible worlds, would prefer to protect their subjective value not through specific performance but rather through stipulated damages, the routinization of the equitable remedy would be superior to the current regime but not as desirable as one in which *any* stipulation is available. The only group whose costs of contracting are likely to increase under specific performance are those transacting in homogene-

123. Those costs will be minimized only if the option of stipulating damages up to the amount of their subjective valuation is made routinely available.

ous goods. They would be obliged to stipulate money damages in order to avoid being specifically bound in the event of breach. This increase, however, is not likely to be large because boilerplate stipulations should become widely and inexpensively available.

C. *Post-Breach Costs and Specific Performance*

The literature on the efficiency of specific performance has concentrated on its post-breach negotiation costs. The consensus seems to be that these costs will be higher than those under money damages. There are sound reasons for questioning this conclusion. First, even if post-breach negotiating costs are higher under specific performance, they may be more productive at guaranteeing only efficient breach of contract. Second, post-breach costs may be high only during a transition period during which contractual parties adjust from damages as the principal contract remedy to specific performance as the routine remedy. As noted in the previous section, if the equitable remedy becomes widespread, the process of contract formation will become more efficient, leading, *ceteris paribus,* to fewer contract disputes. Third, court costs under specific performance will be less than under money damages. This is because there will be fewer contract disputes and, because the costs to promisees of protecting their subjective valuation of performance will be reduced, they will not have to make elaborate and expensive showings to the court of the inadequacy of money damages.

Let us take these costs up in turn.

1. *Transaction Costs, Again*

Recall the Calabresi-Melamed framework, which suggested that the most efficient remedy for a court to impose in a dispute was to be determined by examining the transaction costs facing the disputants. The presumption is that, when transaction costs are low, the market is superior to court proceedings as a method of determining relative valuation. If, however, transaction costs are high, then a market exchange could not resolve the dispute, and the court should perform a hypothetical market analysis by setting a level of money damages to approximate the price at which the plaintiff would have sold his entitlement to the defendant if transaction costs had not been too high to frustrate such an exchange.[124] I argued above that the application of this theory to contract remedies urged specific performance as the routine remedy on the grounds that, in general, the transaction costs be-

124. *See* notes 90-97 *supra* and accompanying text.

tween contractual parties were not high.[125] We must now examine this contention in more depth.

The principal reason for presuming low transaction costs as the general condition among contracting parties is that, by the time a breach appears, the parties have already done a substantial amount of negotiating. Relatively speaking, the costs to them of negotiating a mutually satisfactory (and efficient) conclusion to the breach are low.

There is a powerful point to be made in rebuttal to this presumption of low transaction costs: If the costs of resolving the dispute voluntarily are low, why are the parties in court? Should the presumption not be that, when contractual partners come to a court for resolution of a dispute, their transaction costs *must* be high; otherwise, they would have negotiated a settlement?

Despite its plausibility, this point is incorrect. First, parties whose transaction costs are low may be induced to go to trial rather than settle if there is some uncertainty about what the law is or what it will do in a given fact situation.[126] Suppose, for example, that the innocent party to a breach believes strongly that money damages will undercompensate him because he places a high subjective valuation on performance. He is certain that the breacher will not believe or support this claim in a settlement, but he has hopes that the court will be persuaded of the inadequacy of money damages and will award specific performance. If the defendant-breacher believes that the claim for inadequacy of money damages is not likely to be persuasive to the court, he then considers it likely that he will do better at trial than from settling.[127] Under those circumstances, not unlikely under current contract law, the parties will go to trial, despite the low transaction costs between the parties.[128]

Second, parties might prefer trial to further negotiation if they have come to the stage in their relationship in which passions have run so high that they can no longer profitably talk to one another either

125. I also noted that there was more to the argument than the mere level of transaction costs. It might be, for example, that even though the transaction costs are not very low, the costs to a court of determining the expectancy of the promisee are so high that it would be cheaper to leave that determination to negotiations between the parties affected by involving specific performance. *See* text at notes 136-40 *infra*.

126. *See* Cooter & Kornhauser, *supra* note 12, at 150-56. Priest & Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1,14-16 (1984), argue that the further each party's estimate of its fault is from the true standard the less likely is litigation.

127. In order to make the point, the example has ignored the complications introduced from assuming that litigation is expensive.

128. Note that if specific performance were the routine remedy, the parties in this hypothetical would not do better at trial than they would in settlement. *See* text at notes 122-23 *supra*.

directly or through their representatives, say, their lawyers.[129] The argument would be that, when the possibility of negotiations has disappeared, the transaction costs between the parties have become so high that equitable relief can no longer be relied upon to lead to an efficient solution, and so courts should then award money damages. There can be no doubt that this sort of thing happens, but it is not at all clear that an efficiency-based legal rule should take this to be an instance of the sort of high transaction costs that invoke a damages remedy. The reason for this has to do with the difference between objective and subjective transaction costs.

Calabresi and Melamed did not distinguish between objective and subjective transaction costs, but for their theory to be a reliable guide to legal efficiency the distinction is crucial. By objective transaction costs I mean the transaction costs that reasonable people in an objectively similar situation would face. The principal determinants of the level of objective transaction costs are the number of parties involved in the potential transaction, the complexity of the exchange envisioned, and the costs of enforcing that exchange.[130] Determining the level of these costs in any given situation is not an exact science. Nonetheless, the conditions under which transaction costs are likely to be high are sufficiently well known that they can be predicted in most instances. Moreover, the concept of objective transaction costs should not arouse much controversy in the law because of its close resemblance to the law's widely-used "reasonable person" standard, itself a measure of objectivity. The more important point here is that the subjective transaction costs of the particular litigants before the court are not, in general, relevant to the court's goal of fashioning an efficient rule of contract law. This means that whether the particular breacher and breachee before the court are still on speaking terms should *not* guide a court in choosing its remedy.[131]

Even if it is granted that transaction costs between contractual parties are not, in general, high, a second objection has been raised to reliance upon voluntary post-breach negotiations to resolve the breach efficiently. Whenever an outcome of a bargain or game is uncertain and subject to negotiation, the parties to the game have an incentive to engage in strategic behavior — to posture, bluff, and in other ways

129. *See* G. WILLIAMS, LEGAL NEGOTIATION AND SETTLEMENT 48-52 (1983).

130. Although no one has called these "objective" transaction costs, these are the most common elements of the usual list of those costs. *See* H. KOHLER, *supra* note 3, at 32-33.

131. This is not to say that there are never any subjective conditions or attributes of the disputants that should be counted as transaction costs in applying the rule proposed by Calabresi and Melamed.

attempt to secure for themselves as large a share of the bargain as possible. Since it is very difficult for either party to determine when the other is bluffing, it may be that an otherwise efficient exchange is frustrated by this strategic behavior. One party may misperceive the other's position and hold out for more than the other is prepared to pay. The worry is that at some point no further bargaining will take place and the entire exchange will be frustrated.[132]

Clearly, strategic behavior is present in almost all negotiations, but it is not at all obvious that strategic behavior frequently or even very often prevents an asset from moving to its highest-valuing user. Indeed, most casual observers of negotiations and bargaining would be inclined to call strategic behavior the essence of the market process; that is, it seems to be very difficult to distinguish strategic behavior from the very sort of haggling and bargaining that are among the most distinctive characteristics of voluntary exchange. Given this, it makes little analytical sense, and would seem to be extremely unhelpful, to claim that market behavior is efficient when there is not strategic behavior and inefficient when there is.

Moreover, nearly all of the examples of efficiency-frustrating strategic behavior[133] do not stand up to scrutiny. For that behavior to frustrate an otherwise wealth-maximizing exchange, one party must at some point simply abandon the field and refuse to negotiate further. Why is it to be assumed that this refusal is inefficient? Perhaps the party who has abandoned the negotiation has determined that he gets greater utility from doing so than from completing the exchange, in which case the lack of a completed exchange is not inefficient at all. Perhaps the refusal to deal is yet another bargaining ploy designed to induce the other party to reveal more information. In that case, there may well be an exchange at some future date when new information is brought forward or when one party reopens the negotiations. It would be premature to claim that the breaking off of negotiations in this example has frustrated a wealth- or value-maximizing exchange. At what particular point one chooses to say that strategic behavior has

132. *See* Polinsky, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 STAN. L. REV. 1075, 1078 (1980).

133. *See* Polinsky, *supra* note 132, at 1078; *see also* Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 17-18, 20-27 (1982), for additional examples. Some commentators, *e.g.*, R. POSNER, *supra* note 1, at 45, consider strategic behavior to be most likely to arise in situations of bilateral monopoly. A bilateral monopoly arises when a single buyer and a single seller face one another. The price and output that result are not determinate, as they are when there are competing sellers or competing buyers. *See* J. HENDERSON & R. QUANDT, MICROECONOMIC THEORY 244-49 (1971). The economic literature stresses this *indeterminacy* of price and quantity in bilateral monopoly. Nowhere does that literature suggest that an exchange will not take place between the monopolists.

caused the collapse of negotiations is no more precise than is the designation of which kind of strategic behavior fosters exchange and which kind frustrates exchange. This makes the notion less than helpful in analyzing voluntary exchange.

There is another sense in which the notion of strategic behavior is not germane to an efficiency analysis of contract law. Strategic behavior is most frequently associated with negotiations over the division of the surplus from an exchange, not with whether an exchange should take place. In the example above of a contract for the sale of a house, the negotiations between *A* and *B* over which of them should realize the surplus from selling the house to *C* are likely to be attended by strategic behavior. As we saw, however, the distribution of this surplus between *A* and *B* is not at issue in an efficiency analysis.[134] The primary issue was how the house could be moved to the highest valued user, here *C*, at the least cost and in a fashion that will create an efficient rule of law to guide future contracting parties. The equity issue of which party should be the principal beneficiary is secondary, and, as we shall see, the distribution of that surplus is not a function in which the courts have a comparative advantage over other institutions in society. Thus, because strategic behavior is most likely to arise where there is a surplus to be distributed, the most that can be said against it is that it will frustrate redistribution of that surplus, not that it will frustrate an efficient exchange.[135]

2. *Court Costs*

By court costs I mean all the costs of using litigation to resolve a contract dispute in which the innocent party is asking for specific performance. The purpose of this examination is to compare those costs with the costs of determining the level of money damages that would make the innocent party just as well off as if the contract had been performed. Thus, the comparison is not between the court costs of legal and equitable remedies under the current regime in which money

---

134. *See* text at note 98 *supra*.

135. These same shortcomings in the interpretation of strategic behavior apply to the contention that injunctive remedies create an incentive for the party holding the injunction to extort the other party. *See* Polinsky, *supra* note 132, at 1077-78. At best, this extortion is really a distributional issue, not an efficiency issue. One might also contend that, in the contract breach setting, the defendant knew or should have known of the possibility of his being "held up" by the plaintiff if specific performance were granted upon breach. Having known of this possibility, the defendant should, therefore, have discounted the loss upon breach by its probability of occurring. Since that calculation could have been made at reasonable cost, there would be no efficiency reason for the court's redistributing the surplus from breach: the defendant has been compensated *ex ante* for assuming the risk that a better buyer will appear before the completion of the contract.

damages are presumed to be adequate unless the breachee makes a convincing showing of their inadequacy. Rather, the comparison is between two different systems: in one, money damages is the routine contract remedy; in the other, specific performance is the routine remedy. I shall assume that in both systems the goal of the law is to protect the breachee's expectation interest in order to induce promisors to breach only when it is Pareto-efficient to breach.

When money damages are the routine remedy for breach of contract, the informational demands on a court in reaching the efficient level of damages are extremely large. It is agreed that the plaintiff's expectation interest must be protected in order to guarantee that the contractual performance will accrue to the party who values it the most. In the case of seller's breach, this means that the difference between the buyer's reservation price for the performance and the contract price must be awarded to insure a Pareto-efficient breach. Absent contractual language specifying what that reservation price is, this is a formidable evidentiary task. As noted above, at trial the buyer has every incentive to exaggerate his reservation price. Thus, the court must evaluate the innocent buyer's evidence on the value to him of the performance. Where the performance involves a fungible good, it is true that there is not likely to be a subjective valuation of the good that is different from the contract or market price of the good. Nonetheless, the court concerning itself with efficiency and determined to protect expectancy through the assessment of money damages must take pains to see that, even with the fungible good, there is not an expectation interest that will be frustrated by an award only of the contract price. Where the performance is not fungible, the evidentiary problems multiply.[136]

Whether the performance concerns a unique or a fungible good, the court costs associated with specific performance are likely to be less than those associated with assessing money damages. With specific performance the court's inquiry, with an exception noted below, ends with a determination that there has been a breach. Once that determination has been made, the parties to the contract resolve the matter of the breachee's expectancy through negotiations. With money damages, the court must determine whether there has been a breach *and* the amount of damages that will efficiently compensate the innocent promisee. In terms of court costs, the distinction between the

136. It was a desire to avoid precisely these evidentiary problems by encouraging contracting parties to exchange information about subjective values on performance that was at the heart of the argument for the general enforcement of liquidated damages clauses, even those with a seeming punitive element. *See* notes 29-43 *supra* and accompanying text.

two forms of contractual remedy is much like that between negligence and strict liability in tort law. It has been argued that strict liability is the more efficient standard in that its administrative costs are so much less than those of the negligence standard.[137] In strict liability the plaintiff must demonstrate by a preponderance of the evidence that the defendant caused him harm. He need not make a showing of the defendant's lack of care. When the standard for judging the defendant's liability is negligence, the plaintiff must show that the defendant caused him harm and that, in doing so, the defendant was not living up to a reasonable standard of care.[138] It is this second burden on the plaintiff in negligence that increases his costs in the same way that court determination of expectancy increases the costs of money damages as the routine contract remedy.

In summary, the court costs attending specific performance are likely to be less than those attending legal relief. Less must be demonstrated by the injured promisee, and the costs of determining the promisee's expectancy are left to negotiations between the promisee and promisor rather than being determined through evidentiary proceedings. The only valid argument against specific performance as the routine remedy on the basis of court costs is that specific performance might involve high supervisory costs, making it less efficient than money damages.[139] But as we shall see more fully below, this criticism is overdrawn. It should and does form the basis for a special defense to an action of specific performance,[140] but it is most likely to arise in a relatively limited class of contracts, *viz.*, personal service contracts. Even in that limited class, the inefficiencies attributable to specific performance because of high supervisory costs will be shown to be exaggerated.

3. *Relative Cover Costs*

In the recent literature on the efficiency of various contract reme-

137. *See* Posner, *Strict Liability: A Comment*, 2 J. LEGAL STUD. 205, 209 (1973). Judge Posner also notes that, because the costs to plaintiffs of bringing a claim under a strict liability standard are so much less than those under a negligence standard, strict liability may lead to more claims or to more being spent on each claim. The net result of a switch from negligence to strict liability might then be an increase in the total costs of trials. *Id.* at 209.

138. RESTATEMENT (SECOND) OF TORTS §§ 289-296 (1965).

139. RESTATEMENT OF CONTRACTS § 379 comment d (1932):

> The refusal of affirmative specific enforcement in these cases is based in part upon the difficulty of enforcement and of passing judgment upon the quality of performance, and in part upon the undesirability of compelling the continuance of personal association after disputes have arisen and confidence and loyalty are gone. In some cases the decree would seem like the enforcement of involuntary servitude.

140. *See* notes 188-95 *infra* and accompanying text.

dies, the matter of relative cover costs has received much attention.[141] The issue has to do with whether the seller or the buyer, after a breach, has access to the market at lower cost and whether, therefore, damages or specific performance is the more efficient remedy. Consider the case of seller's breach. Suppose that there is reason to believe that the buyer is better able to cover than is the seller. It might be, for example, that the buyer can buy from the seller's competitors more cheaply than can the seller,[142] or that the buyer is more aware of his idiosyncratic needs than is the seller.[143] The total resources consumed in moving the good to its highest-valued use are then minimized by making the buyer responsible for covering since he is the party who can cover more cheaply. Under a rule of money damages it is indeed the buyer who would cover. It is argued that, if specific performance were the remedy, then the buyer — here assumed to be the cheaper coverer — would inefficiently leave to the seller the task of finding substitute performance.[144] On the other hand, if it is less expensive to have the breaching seller perform than to have him pay damages to the buyer and to have the buyer cover, then specific performance may be the preferred remedy.[145] Professor Schwartz has argued that no general presumption holds: buyers and sellers have similar cover costs so that this cannot be used as a device for deciding which remedy, damages or specific performance, is more efficient.[146]

He considers four possible objections to this conclusion. First, it might be argued that if buyers have generally lower cover costs but the routine remedy is specific performance, this difference in cover costs could induce buyers to breach in order to use post-breach negotiations to redistribute the gains from breach to themselves. This objection makes the unwarranted assumption that the difference between seller's and buyer's cover costs is greater than the buyer's lawyer's fees and other court costs.[147]

Second, it might be objected that specific performance will induce excessive post-breach negotiation costs in the extreme circumstances in which the seller cannot cover at all. This might be the case if the seller is a monopolist or if the contractual good is unique. In those

141. *See* Schwartz, *supra* note 6, at 287; *see also* Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365, 1380-82 (1982).

142. Yorio, *supra* note 141, at 1384.

143. *Id.* at 1384-85.

144. *Id.* at 1385.

145. *Id.*

146. Schwartz, *supra* note 6, at 287.

147. *Id.* at 287-88.

cases, however, the buyer cannot cover either, so that there is no reason to believe that post-breach negotiation costs will be higher under one remedy than under the other.[148]

Third, specific performance may generate higher post-breach negotiation costs when there are two buyers and the first buyer's intended use for the seller's good is fungible while the second buyer's is not.[149] Consider a contract for the sale of farmland. The original buyer intends to use the land to farm, but prior to delivery a second buyer appears with a unique plan for the land and an offer to pay more than the original buyer. The seller refuses to perform in the hope of selling to the second buyer. The objection to specific performance in this circumstance is that, since the cover costs for the first buyer are low, he should be given money damages in order to minimize the post-breach costs of moving the land to the highest-valued use. Under specific performance, the first buyer would likely engage in protracted negotiations in order to capture some of the seller's profit from the sale to the second buyer.[150] Presumably, the suggestion is that an exception be made to specific performance as the general rule in these circumstances. Yet the litigation costs of determining whether a given fact situation fits this exception are likely to be high — higher, in general, than the efficiency gains from suspending equitable relief.[151]

Fourth, when there are changed circumstances, the transaction costs of resolving a breach through negotiations are higher under specific performance than under money damages. Consider rapid inflation. Professor Schwartz gives the following example.[152] A buyer has contracted for construction of a building at $10,000 from which he will realize a profit of $3,000 upon completion. The contractor anticipated that the construction would cost him $8,000, but because of unanticipated inflation his costs have risen to $15,000. The promisor would prefer to breach, all other things equal, and pay the buyer his expectancy of $3,000, rather than to incur the additional costs of $7,000. It is cheaper for him to breach than to perform, and because the buyer can be made just as well off as he would have been had the

148. *Id.* at 288.

149. The difference in the two buyers' uses is necessary in order for there to be a particularly large gain at stake from reselling to the second buyer. If the second buyer is planning the same sort of use as the first buyer, then the price he would be willing to pay the seller would not be significantly different from the original contract price. Thus, there would not be much surplus from moving the contractual good to its highest-valued use, and, as a result, there would not be much to be gained from protracted post-breach negotiations between the first buyer and the seller.

150. Schwartz, *supra* note 6, at 289-90.

151. *Id.* at 290.

152. *Id.* at 290-91.

contract been performed, breach and the payment of expectation damages would appear to be Pareto-efficient. However, if specific performance is the routine remedy, the promisee will threaten that remedy in order to force the contractor to pay him more than his expectancy. The promisor should be willing to pay up to slightly less than $7,000 in order to be relieved of having to perform. The situation will not, however, be materially different under the damage remedy. Since the standard remedy for breach of a construction contract is the difference between the contract price and the new market price,[153] the promisee can still force negotiations because he retains the power to impose a $7,000 loss on the contractor, even under damages. This is because the new market price would be $17,000 — the $15,000 costs plus $2,000 profit — which is $7,000 greater than the contract price of $10,000. Thus, in changed circumstances there is no greater post-breach efficiency loss under specific performance than there is under money damages.

There are two further points, not raised by Professor Schwartz, to be made about relative cover costs and the efficient contract remedy. The first is that the contracting parties may well have taken into account in the contract price their relative advantages in access to the market in the event of breach. The party with the superior ability may well have used that fact to offer more attractive contract terms. If so, then the matter of who should bear liability for covering in the event of breach becomes a matter of determining the parties' implicit assignment of the risk of a particular contingency. For example, if the seller is better placed to cover in the event of breach, then, all other things equal, he should be able to offer this superiority to the buyer in exchange for a higher contract price discounted by the probability of the breach. Suppose that the seller can access the market for $100 less than can the buyer. If both parties estimate that there is a 0.5 probability of breach, then a risk-neutral buyer should be willing to pay $50 more for the seller's performance in exchange for assigning the risk of covering in the event of breach to the seller. The seller should be willing to accept $50 more for assuming this risk. If the parties have assigned the risk of breach in this manner, there should be evidence of that in the contract price and, perhaps, in the language of the contract.

The second point is that it is an overstatement to call the post-breach negotiation costs a deadweight efficiency loss in so far as they serve only to redistribute wealth.[154] In some of the circumstances de-

153. RESTATEMENT OF CONTRACTS § 346 (1932).

154. Schwartz, *supra* note 6, at 285.

scribed above, there may be such deadweight losses. It is vital to note, however, that these short-term efficiency losses may lead to a superior exchange of mutually beneficial promises in the future and so pay for themselves. Suppose that the court imposes specific performance in an instance in which the buyer has lower cover costs than the seller, who has breached. From the discussion above we know that this will lead to higher post-breach negotiation costs than if the court awarded money damages. Nonetheless, consider the effect of this award of specific performance on the behavior of future contracting parties. A future seller aware of the fact that the buyer has lower cover costs will insist on taking this fact into consideration in framing the terms of the contract. He should, for example, be willing to offer a lower contract price, discounted by the probability of breach, in exchange for the buyer assuming the risk of covering in the event of breach. The buyer should be willing to assume this risk in exchange for a lower contract price. Both parties are better off knowing that this assignment of risk will save them losses associated with negotiating about the division of the gains from breach. Thus, specific performance will lead to more efficient contracting by encouraging a more efficient exchange of mutually beneficial promises in the future. The short-term efficiency losses that occur are transitory and should not form the basis of a general argument in favor of money damages. That is, these losses should be balanced against the present discounted value of the resulting increases in the efficiency of exchanging promises in the future plus the present discounted value of the savings from reduced uncertainty about and from litigation over the terms of future exchanges. When this is done, it may well be shown that the most efficient way to encourage more efficient future contracting is to impose some deadweight losses on the immediate parties.[155]

4. *Mitigation*

A matter related to cover costs is mitigation. This concept has not much figured in the debate on the most efficient contract rem-

155. This point has wide application. A court concerned with establishing efficient rules of law may find itself imposing what appear to be inefficient, wasteful losses in an effort to influence future behavior to become more efficient. Perhaps the best example of this is the famous case of Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239, 129 N.E. 889 (1921). There a contractual clause called for the use of a particular brand of pipe in the construction of a house; the contractor substituted an alternative. In holding that the buyer owed the balance due on the contract, the court said that it would be wasteful to require the contractor to incur the extraordinarily high costs of tearing up the interior walls in order to put in the proper brand of pipe. While in this case there might have been inefficiencies from enforcing the terms of the contract, there is no doubt that if the court had imposed them on the contractor, future contractors and others would have been more efficiently cautious about taking it upon themselves to make substitutions without consulting the other party.

edy,[156] but clearly it should. We should like to know the relative efficiency of legal and equitable relief with regard to their ability to induce efficient mitigation after the breach. With money damages there is an obligation on the breachee to mitigate his losses,[157] and it is generally conceded that this is an efficient obligation.[158]

With specific performance there is no such obligation to mitigate, nor is it easy to see how such an obligation could be imposed under that contract remedy.[159] This raises the concern that under specific performance as the routine remedy there would be avoidable inefficiencies in that the promisee would no longer have the duty to mitigate his losses from nonperformance. If this is true, it may constitute a strong argument for retaining money damages as the routine contract remedy. In order to rebut this argument it is necessary to show that specific performance will *not* inefficiently induce promisees not to mitigate their losses.

Let us begin by noting that the duty to mitigate should be interpreted to cover not merely the duty regarding the solitary, post-repudiation actions of the promisee but also the duty on both parties to make what Professors Goetz and Scott call a cooperative readjustment.[160] The previous discussion of post-breach negotiation costs has already touched on mitigation in this second, cooperative sense.[161] Here I will draw special attention to the relationship between the alternative contract remedies and the post-repudiation actions of the promisee. I shall discuss two different cases of buyer's breach: the first involving a perishable commodity; the second, an imperishable commodity. Both commodities will be assumed to be fungible. I shall not discuss cases of seller's breach, nor of the difference between unique and nonunique goods. The analysis of those situations follows that developed here for the cases of buyer's breach.

Consider a contract for the sale of a perishable product like toma-

---

156. The exception is Goetz & Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967 (1983).

157. RESTATEMENT (SECOND) OF CONTRACTS, § 350(1) comments b & c, illus. 1-5, 7 (1979); *see also* U.C.C. §§ 2-708(1), 2-713(1), 2-715(2)(a) (1977).

158. Goetz & Scott, *supra* note 156, at 973.

159. One possibility is a conditional specific performance decree. The breachee would be awarded equitable relief on the condition that he had taken steps to mitigate his losses. *See* Rabin, *supra* note 91. It is possible that a court would interpret the restriction that those seeking equitable relief have "clean hands" as implying that they had taken steps to mitigate their losses. In any event, the argument developed below suggests that there is no need to make the award conditional, either explicitly or implicitly, since the breachee has precisely the same incentive to mitigate under unconditional specific performance as he has under money damages.

160. Goetz & Scott, *supra* note 156, at 1011.

161. *See* notes 122-28 *supra* and accompanying text.

toes. Suppose that *B* agrees to purchase 100 tons of fresh tomatoes from *S* at $100 per ton. *S* will realize a profit of $2,000 on the sale. *S* secures the produce, but *B*, a restaurateur, has suffered a financial setback and announces his intention to breach the contract. If the routine contract remedy is money damages, then *S* will be entitled to his expectancy, $2,000, plus any incidental costs incurred in trying to mitigate his losses by selling the tomatoes elsewhere.[162] If the routine remedy is specific performance, then there is a fear that *S* will simply allow the tomatoes to rot or that, more likely, his incentive to resell them is less than is the case with money damages. Alternatively, specific performance may induce *B* to take delivery of the tomatoes, pay *S* $10,000, and attempt to resell them himself. If *B* is less advantageously placed to resell than is *S*, then it might be argued that specific performance has created an inefficiency by placing the duty to cover on the party with the higher cover costs.[163]

This inefficiency is illusory. *B* need not take delivery under specific performance, nor necessarily pay more in settlement to *S* than if a court awarded *S* his expectancy plus incidental expenses in reselling. If *B* would rather not be saddled with the costs of reselling the tomatoes, then he can purchase *S*'s right to enforce the contract from *S* for $2,000 plus *S*'s costs of resale. This will satisfy *S* since he is, by definition, doing as well as if *B* fully performed.[164] *B* is better off in paying this sum than in taking delivery if his resale costs are greater than *S*'s. Note that this is precisely the outcome that would have resulted if money damages were the routine remedy. Thus, with regard to perishable commodities, the result of a buyer's breach is the same whatever the contractual remedy. Neither remedy is more efficient than the other. This means that, even without a duty to mitigate under specific performance, the incentives facing both promisee and promisor will lead to a mitigation of the losses arising from the buyer's breach.

When we turn to the duty to mitigate when the object of the breach is a nonperishable commodity, the issues become more complex but the conclusion is the same. Consider a contract between *L*, a

162. Neumiller Farms, Inc. v. Cornett, 368 So. 2d 272 (Ala. 1979); U.C.C. § 2-708(1) (1977). I mean to leave aside the complex questions of whether this seller has really suffered any loss in profits because of the buyer's breach. Let us assume that this is truly a case of lost-volume sales and, therefore, of lost profits.

163. This point indicates the very close connection between the matter of relative cover costs, dealt with in the previous section, and mitigation.

164. *B* may even pay *S* a bit more than the sum mentioned. At $2000 plus the costs of resale, *S* would be indifferent between this sum and receiving specific performance. For a little more, *S* would *prefer* to sell his right to specific performance. *See* text at notes 39-40 *infra*.

landlord, and *R*, a renter, for the rental of *L*'s property at a fixed monthly rate for a term of five years. After two years *R* finds it no longer profitable to continue the rental and announces his repudiation of the contract. Under a rule of money damages, *L* is entitled to his expectancy but has a duty to try to relet the property in order to mitigate his losses. Generally speaking, *L* may not simply bring an action to collect the remaining three-year's rent. Under the duty to mitigate *L* may recover any incidental expenses involved in reletting the property plus the difference between the contract price and the new rental rate.[165] It is feared that under specific performance *L* will have no incentive to mitigate; instead, he will inefficiently hold *R* to the terms of the rental contract rather than making efforts to move his property to its next best use.

It is not at all clear that even under money damages *L*'s behavior will be different when he has a duty to mitigate than when the law imposes no such duty. That is, regardless of the contract remedy and of any duties imposed, *L* might want to try to mitigate his losses by reletting his property after *R*'s breach. Assume that under legal relief *L* is entitled to the remaining three-years' payment on his contract and that there is no obligation on him to minimize his losses. *R*, who now faces the responsibility of paying the remainder of the contract, will attempt to relet the property himself, assuming that he is not prevented from doing so by the terms of the contract.[166] *R* may not be able to relet the property as efficiently, *i.e.*, as cheaply, as could the landlord. Nonetheless, with no duty on *L* to mitigate, *R* will attempt to mitigate *his* losses by reletting the property. It is even possible that, if *L* has an appreciable cost advantage in reletting the property, *R* will pay *L* something less than his cover costs but greater than *L*'s cover costs to induce *L* to assume the duty to find another lessee. Both parties would be better off under such an arrangement than if the inefficient party, *R*, were to attempt the reletting alone.

What this means is that, even under money damages without a duty on the seller to mitigate, there are strong incentives for a mutually beneficial post-breach agreement between buyer and seller to minimize the losses from breach.[167] Precisely the same sort of conclusion

165. BVA Credit Corp. v. Fisher, 369 So. 2d 606 (Fla. Dist. Ct. App. 1978); Industrial Leasing Corp. v. Thomason, 96 Idaho 574, 532 P.2d 916 (1974).

166. If there is such a restriction in the contract, then it is possible to infer that *R* voluntarily assumed the risk of being obliged to pay the entire rental term. Perhaps *R* received a lower rental rate in return for assuming this risk. Alternatively, he can, after the breach, purchase the right to relet from *L*. *See* text following note 168 *infra*.

167. The possibility for a post-breach settlement leading to an efficient outcome is reminiscent of the argument that such a settlement will forestall the inefficient performance of a contract where there is a punitive liquidated damages clause. *See* text at notes 39-40 *supra*.

follows when the routine remedy is specific performance. If *L* is entitled to that remedy, then after the breach he and *R* stand in relation to each other in exactly the same manner as they did under money damages without a duty on *L* to mitigate his losses. We saw there that a private settlement would minimize losses in precisely the manner envisioned to occur through a legal duty to mitigate; hence it follows that under specific performance there will also be an incentive for *L* and *R* to minimize the losses from breach through a private negotiation that is indistinguishable from a legal duty to mitigate.

Let us consider an extreme case: *R* has rented *L*'s premises for five years under the condition that he use the property only as a saloon; furthermore, he is forbidden to sublet the premises during the term of the lease.[168] After two years, the county in which *R* has been operating his saloon suddenly and unexpectedly makes the sale of alcoholic beverages illegal. *R* breaches his contract with *L*, and *L* sues for specific performance. Under that remedy, might it not be the case that *R* will be inefficiently bound to pay *L* the remaining three-years' rental? Although *R* has no right to sublet, he does have at his disposal the opportunity to buy from *L* the right to enforce the decree of specific performance. Clearly, *L* will not sell that right for less than *R* is obliged to pay him under the contract. Consider the possibility that *R* paid a lower than market rental rate for *L*'s property precisely because *L* insisted on the limitations that it not be sublet and that it be used only as a saloon. Suppose that without those restrictions the monthly rent would have been $600, but that with them it was $500. Under specific performance *L* is entitled to a stream of income of $500/month for another three years. Only if *R* is able to pay him more than that will *L* consent to release him from specific performance on the original contract. There is every reason to believe that *R* will pay him, say, $550 per month in return for *L*'s waiving the restrictions on subletting and use of the premises for another purpose. *R* will be willing to pay that increased amount if there is an alternative use of the property that makes the payment of $550 per month profitable to him.

In conclusion, the alternative contract remedies are equally efficient as regards the incentive to mitigate the seller's losses in the case of buyer's breach. A choice between legal and equitable relief may, therefore, be made on the basis of the other attributes discussed above.

168. *See, e.g.*, Peterson v. Jefferson County, 372 So. 2d 839 (Ala. 1979); Lloyd v. Murphy, 25 Cal. 2d 48, 153 P.2d 47 (1944); Mitchell v. Ceazan Tires, Ltd., 25 Cal. 2d 45, 153 P.2d 53 (1944).

5. *Consequential Damages*

One of the common rules in assessing contract damages is that the innocent party is not, in general, entitled to collect for his consequential damages.[169] The rule derives from the doctrine of foreseeability of contract damages enunciated in the celebrated case of *Hadley v. Baxendale.*[170] That doctrine holds that the breacher is to be held liable only for the reasonably foreseeable losses arising from his breach, unless he was notified of and agreed to accept liability for remote damages.[171]

The economic rationale for this rule is that the breachee is likely to be a better insurer against or preventer of certain remote losses than is the breacher.[172] For example, consider a person who has funds transferred to his United States bank account electronically from overseas.[173] Due to an error on the part of the transmitting bank, the funds arrive after an unanticipated delay. As a result, the person expecting the transfer misses the deadline for the purchase of tickets to an event for which he has an extremely high subjective valuation. He sues for breach and asks for the extraordinary losses — the difference between his subjective valuation of the tickets and the actual ticket prices. Assuming that the breach is not excusable, the court will allow the recovery of only the ticket prices, not the extraordinary losses. The reason is that the transferor had no way of foreseeing the very large losses of the transferee. Indeed, if the law were to hold the transferor liable for *all* the losses of the transferee, then transferors would increase their prices to reflect this increased risk of doing business. This result would be inefficient in that *all* customers would be obliged to contribute to this loss insurance. It would be less costly to relieve those with only ordinary losses from the cost of contributing to this

---

169. Prior to the adoption of the U.C.C., most states held that consequential damages were awarded only if the seller knew of the buyer's purpose in making the purchase and if no substitute good would be available in the event of the seller's breach. Marcus & Co. v. K.L.G. Baking Co., 122 N.J.L. 202, 3 A.2d 627 (1939). U.C.C. § 2-715(2) (1977) maintains the common law requirements, providing that the seller must pay consequential damages for "any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise." *See also* United Cal. Bank v. Eastern Mountain Sports, Inc., 546 F. Supp. 945, 966-72 (D. Mass. 1982), *affd. mem.*, 705 F.2d 439 (1st Cir. 1983). Some commentators suggest that the standard under the U.C.C. relaxes the requirement of foreseeability. *See* J. CALAMARI & J. PERILLO, CONTRACTS 551-53 (2d ed. 1977).

170. 156 Eng. Rep. 145 (Ex. 1854).

171. RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979); J. CALAMARI & J. PERILLO, *supra* note 169, at 523-26.

172. R. POSNER, *supra* note 1, at 94. Note the close connection between consequential damages, the issue of relative cover costs, and the doctrine of mitigation.

173. *See, e.g.*, Evra Corp. v. Swiss Bank Corp., 673 F.2d 951 (7th Cir.), *cert. denied*, 459 U.S. 1017 (1982).

special insurance fund and instead to place the full cost of insurance against extraordinary losses on the few who anticipate such losses.

Because there is an efficiency reason for limiting a breachee's losses to those that are reasonably foreseeable, the question arises as to whether this limitation will be preserved under specific performance as the routine remedy. At first blush, there would appear to be no such limitation: the breachee, in his post-breach negotiations, would seek to recover *all* his losses, foreseeable or not. Without limitation imposed by the court, specific performance would seem to lead to the possibility of the innocent party's inefficiently recovering too much.

This conclusion would be incorrect. First, while it might be true that in the initial instances of awards of specific performance as the routine remedy the breachee would press for more than he would have recovered under money damages as tempered by foreseeability or a duty to mitigate, this over-recovery would not persist for future contracting parties. If it were known that the breachee could, under specific performance, hold out for foreseeable and extraordinary losses, then a limitation would likely become a part of the contract itself, either in the form of a waiver of liability for consequential damages[174] or as specified in a liquidated damages clause.[175] Bargaining at contract formation time about either of those alternatives would lead to an efficient assignment of liability: if the potential breacher were the superior risk-bearer for *all* the potential breachee's losses, he should be willing to assume liability for *all* losses in exchange for a slightly higher contract price. If, on the other hand, the breachee is better placed to insure against or prevent some but not all losses, then responsibility for those different types of loss should be exchanged in a value-maximizing way.[176]

Second, the situation in which the breachee recovers both foreseeable and extraordinary losses under specific performance is never likely to arise. This is because, in the situation in which losses have already been incurred and there is no physical way in which performance can be completed by the breacher, specific performance would not be a viable remedy.[177] Money damages will have to do. Consider

174. Kalil Bottling Co. v. Burroughs Corp., 127 Ariz. 278, 619 P.2d 1055 (Ct. App. 1980); Bakal v. Burroughs Corp., 74 Misc. 2d 202, 343 N.Y.S.2d 541 (1972).

175. See the discussion of liquidated damages as a form of insurance for legally uncompensable subjective losses at note 122 *supra* and accompanying text.

176. *See* Schwartz & Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1398-99 (1983); Priest, *supra* note 12, at 66-71.

177. See the discussion of impossibility as a defense to an action for specific performance at note 121 *supra* and accompanying text.

the case of the electronic transfer of funds again. The damage there has already been done; specific performance would be meaningless. Thus, the complaint will be for money damages, and the court can then impose the efficient limitations on the foreseeability of the losses and on the breachee's duty to mitigate his losses.

D. *Defenses*

When, under current law, an aggrieved contractual party asks for specific performance, the defendant is allowed to invoke certain defenses that would not normally be available if the innocent party were asking for money damages. He may claim an inadequacy of consideration,[178] a lack of sufficient security for the promisee's performance,[179] and unilateral mistake by the promisor.[180] There is no sound economic reason for *any* of these defenses in the economic analysis of contract law.[181] Since none of them have found favor as formation defenses, there is no good reason to offer them to defendants for use in

---

178. J. CALAMARI & J. PERILLO, *supra* note 169, at 589 (specific performance will generally be denied if consideration is merely nominal, even if it would be sufficient to support a contract at law). In some jurisdictions the defense is statutory. *See, e.g.*, CAL. CIV. CODE § 3391 (West 1970); Lamb v. Cal. Water & Tel. Co., 21 Cal. 2d 33, 129 P.2d 371 (1942). *See also In re* Estate of Brown, 130 Ill. App. 2d 514, 264 N.E.2d 287 (1970) (allowing inadequacy of consideration as a defense when there has also been procedural unfairness in the formation of the contract).

179. *See, e.g.*, Carmen v. Gunn, 198 So. 2d 76 (Fla. Dist. Ct. App. 1967); CALAMARI & PERILLO, *supra* note 169, at 589; RESTATEMENT (SECOND) OF CONTRACTS § 363 (1979).

180. Clayburg v. Whitt, 171 N.W.2d 623 (Iowa 1969); Damazo v. Neal, 32 Md. App. 536, 363 A.2d 252 (1976); J. CALAMARI & J. PERILLO, *supra* note 169, at 594-95.

181. Those engaged in the economic analysis of the law have, in general, favored the bargain theory of consideration, in which the adequacy of consideration is to be left to the subjective judgment of the contracting parties. *See* 2 W. BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 440 (1776) ("[i]n case of leases, always reserving a rent, though it be but a peppercorn: any of which consideration will, in the eye of the law, convert the gift. . . ., if not executed, into a contract"); *see also* Batsakis v. Demotsis, 226 S.W.2d 673 (Tex. Civ. App. 1949), and R. POSNER, *supra* note 1, at 69-71. The reason that economic analysis favors this theory, rather than one that stresses an objective measure of the adequacy of consideration, is that the theory of consumer choice in modern microeconomic theory is based on the notion of purely subjective individual tastes. In this theory consumer preferences are measured on an ordinal, not cardinal, scale of utility so that interpersonal comparisons of utility cannot be made. That means that modern microeconomic theory recognizes no objective standard for comparing the strength of preference or tastes among consumers. With regard to the matter of remedies for breach of contract, this suggests that there is no basis in economic theory for inquiring into the adequacy of consideration. And even if there were, there is certainly nothing about the particular form of relief for which the innocent party prays that justifies a court's investigating the adequacy of consideration when specific performance is sought but not inquiring into that adequacy where legal relief is sought.

The issue of whether there was sufficient security for the promisee's performance could be analyzed similarly. First, the adequacy of security is a matter best left to the contracting parties' judgment at the time the contract is formed. Second, there is no apparent reason for a court's considering the adequacy of security when equitable relief is sought but not when legal relief is sought.

Finally, neither traditional legal analysis nor economic analysis favors excusing a promisor's performance because of his unilateral mistake. *See* R. POSNER, *supra* note 1, at 71-74. That being so, it is inconceivable that a case could be made for excusing specific performance on the grounds

specific performance actions.[182] I shall not discuss these.

There are two additional defenses, however, to which there is some economic content: difficulty of supervision[183] and impossibility. Let us turn to a discussion of the efficiency of these two defenses.

1. *Impossibility*

The most obvious limitation on the routine award of specific performance in breach of contract is the case of physical impossibility.[184] In the economic literature on contracts, impossibility as a performance defense has been analyzed as a device for encouraging the efficient allocation of risk among contracting parties.[185] It has not been recognized that impossibility also bears upon the design of efficient contract remedies.

When performance by the breacher is literally impossible, economic efficiency is not served by awarding the breachee specific performance. Specific performance is, in those circumstances, of infinite worth: it is the sum for which a promisee to whom the court has awarded specific performance will sell his right to have the contract enforced. Consider the case in which a resort owner has lured clients to his island by promising them lots of sun and warm weather. Instead, there is lots of rain and cold. Assuming that there has been a breach of contract,[186] specific performance is meaningless in those circumstances. Money damages will have to suffice to protect the expectancy of the clients.[187]

---

of unilateral mistake if the promisee asks for specific performance but not if he asks for money damages.

The only consistent thread that runs through the extraordinary defenses allowed a promisor to a decree of specific performance is one that sees these defenses as raising the cost to the innocent promisee of seeking specific performance and, thus, of discouraging him from praying for that form of relief.

182. *See* Schwartz, *supra* note 6, at 296. A concurring inference may be drawn from R. POSNER, *supra* note 1, at 95.

183. *See, e.g.*, Dover Shopping Center, Inc. v. Cushman's Sons, Inc., 63 N.J. Super. 384, 164 A.2d 785 (1960); RESTATEMENT (SECOND) OF CONTRACTS § 366 comment a (1979); 5A A. CORBIN, *supra* note 115, at §§ 1171, 1172; Van Hecke, *supra* note 112, at 13-16.

184. For the sake of convenience, I include under impossibility the case of involuntary breach. See U.C.C. § 2-615 (1977) for the doctrine of commercial impracticability. *See also* Iowa Elec. Light & Power Co. v. Atlas Corp., 467 F. Supp. 129 (N.D. Iowa 1978); RESTATEMENT OF CONTRACTS §§ 454-469 comment a (1932).

185. R. POSNER, *supra* note 1, at 74-9; *see also* Posner & Rosenfield, *Impossibility and Related Doctrines in Contract Law*, 6 J. LEGAL STUD. 83, 90-92, 97-108 (1977).

186. This is a strong assumption. The usual manner in which this hypothetical would be treated is as an instance of fraud. If the resort owner made a fraudulent misrepresentation of the weather, then the contract was invalidly *formed*, in which case the appropriate remedy is recission and restitution.

187. In general, economists have not looked favorably on the defense of commercial impracticability. *See, e.g.*, Joskow, *Commercial Impossibility, the Uranium Market and the* Westing-

2. *High Supervisory Costs*

One of the most troubling issues in making specific performance the routine remedy for breach of contract is that there may be circumstances in which the costs to the court of supervising the performance of the breacher may be inefficiently high.[188] There may be a very high probability of noncompliance, owing, perhaps, to the breacher's having forcefully and convincingly indicated his refusal to comply. The court might find that, under those conditions, it will need to incur extraordinarily large expenses in order that the breacher be held to his promise. The prestige of the court is in some jeopardy and may be damaged in those circumstances; this fact should be taken into account in figuring the costs of specific performance.[189]

Alternatively, the performance contemplated may be so complex as to defy effective supervision. Suppose that *A* contracts with *B* to play Hamlet at *B*'s theater and subsequently *A* refuses to perform. A court will not give *B* a decree requiring *A* to act.[190] It is no doubt true that the costs to the court of judging whether, after *B* has received a specific performance decree, *A* had discharged his contractual obligation, including the quality of his performance, are extraordinarily high. For example, how should the court assure the quality of *A*'s performance as the Prince of Denmark? Perhaps because *A* is in such a pique about his dispute with *B* he might, without stringent supervision by the court, seek to embarrass *B* by the shoddiness of his Hamlet. But how far should the court go? Should it specify gestures, grimaces, smiles, tones of declamation? The problem is a real one that the design of efficient remedies must seriously confront.

The contention is, in part, that high supervision costs will increase the costs of using specific performance as the routine remedy to the point that money damages are more attractive. Consider, for example, that if defendants know that they may be relieved of specific performance when they are able to demonstrate high supervision costs, then they have an incentive to raise that defense in cases where it may be inappropriate. Since this would, in general, raise the costs of litigation, it might make the otherwise more efficient remedy of specific perfor-

---

house *Case*, 6 J. LEGAL STUD. 119, 162-63 (1977). With regard to the concerns raised here, the defense of commercial impracticability, if it is not allowed, does not, like physical impossibility, mean that an award of specific performance is of infinite worth. It merely means that, as with any award of specific performance, the defendant will have to pay for the plaintiff's expectation losses as determined in a post-litigation bargain between the litigants.

188. RESTATEMENT (SECOND) OF CONTRACTS § 366 comment a (1979); *see also* Rubin, *supra* note 36, at 246.

189. 5A A. CORBIN, *supra* note 115, §§ 1171, 1172.

190. RESTATEMENT (SECOND) OF CONTRACTS § 367(1) (1979).

mance more expensive and, therefore, less clearly efficient than money damages. A further contention is that since a far wider set of contracts than is commonly assumed involve high supervision costs, specific performance is inappropriate as the routine contract remedy.

While there is something creditable to this criticism, it must be carefully considered. For this criticism of specific performance to hold true, high supervision costs must attend a large number of contracts, and money damages must be the most efficient means of resolving the breach of those contracts. Neither of these matters can be demonstrated.

First, the set of contracts in which supervisory costs are most likely to be high may be a relatively small class of contracts. The *Restatement* makes a point of excluding from relief by specific performance contracts for personal services, presumably on the grounds that for those contracts a court's supervisory costs are high. Yet for nearly every other sort of contract, there is little reason to believe that the court faces high supervisory costs. Thus, at first blush, it would make economic sense to make specific performance the routine remedy *except* in those cases, like personal service contracts, where supervisory costs are likely to be high.[191]

Second, even where supervisory costs are likely to be high, the inefficiencies that would follow from granting specific performance are exaggerated. There are two reasons for this: the contract may never be performed, and if it is, the promisor's regard for his professional reputation and future employability will temper the incentive to misperform the contract.

The presumption that an award of specific performance will necessarily result in performance of the contract is incorrect. We have seen above that specific performance, like injunctive relief, should be understood as an instruction to the litigants to use the market, rather than the court, to solve their dispute. There is every reason to believe that if *B* is awarded a decree of specific performance against *A* to play Hamlet, the two will begin negotiations to resolve the dispute, with *A* pre-

191. Consider this further example. A couple, *C*, finds that although the wife is capable of becoming pregnant, she is not able to carry the fetus to term. The couple form a contract with *M*, a surrogate mother, who agrees to have the couple's fertilized egg implanted in her womb, to carry the fetus to term, to deliver the child, and then to turn the baby over to *C*. Imagine, first, the complexities of specifying in a contract and negotiating over the relevant contingencies and actions to be taken in the event of those contingencies coming to pass. Imagine, further, the issues that arise if *M* declares her intention to breach and *C* then sues. Assuming that the court finds *M* in breach of the contract, are the costs of determining and awarding *C* their expectancy loss in money damages greater or less than the supervision costs of enforcing specific performance? For a lucid and thoughtful discussion of these and related issues, *see* L. ANDREWS, NEW CONCEPTIONS 226-33 (1984).

sumably willing to pay *B* not to exercise his right to the contractual promise. *B,* for his part, may be willing to exchange that right rather than run the risk of incurring large expenses in policing *A*'s portrayal of Hamlet. That is, it may be mutually beneficial to promisor and promisee to bargain out of performance. Although it is difficult to know a priori when this will happen, the possibility that there will be no performance in circumstances in which supervision costs of the performance would be high should lessen the concern about the inefficiencies that might result. Indeed, it may be that the proper way to consider the problem of high supervision costs is not that it puts extraordinary burdens on the legal system but rather that it merely gives the breacher a much better bargaining position in the post-breach negotiations than would be the case under a contract in which the quality of the breacher's performance was not solely in the breacher's hands. If that is the proper economic analysis of the matter of high supervision costs, then it may well be that specific performance is the preferred remedy there, too. Assuming that the promisor makes a credible threat that supervising the quality of his performance will be high, then the worst that can happen to the promisee is that he accepts, in return for not enforcing his right to specific performance, a price that reflects the contract price less the anticipated supervision costs. Such a conclusion would serve as an inducement for future contracts regarding personal services, or other high supervisory cost activities, to include liquidation clauses specifying responsibility for the costs of monitoring performance. Alternatively, promisees in situations of high supervision costs will discount the contract price they are willing to give a promisor by the probability of breach and by the level of anticipated supervision costs.[192]

Even if there is no exchange of the right to performance results, the force of competition may temper the defendant's urge to misperform in some manner. *A,* for example, must take care for his future employability on the stage — with other promoters, if not necessarily *B* — and this fact may spur him to produce as creditable a Hamlet as if he were acting for the sheer love of it, rather than under threat of contempt of court.[193]

Thirdly, and lastly, the high supervisory costs of equitable relief

192. Rubin, *supra* note 36, at 243-46, argued that specific performance should not be the routine remedy for breach because it is not a self-enforcing remedy and it imposes costs on the public which should be better placed on the contracting parties. He was especially concerned about high supervision costs but did not recognize the possibility that this matter could be adequately internalized.

193. See the discussion of how reputation as a market force may lead to breach only where it is more efficient to breach than to perform at text at notes 17-23 *supra.*

are objectionable in large part because they are incurred at public expense.[194] This objection would be mitigated if the costs were borne by the litigants, not by taxpayers in general. The use of court-appointed special masters to oversee equitable decrees is one means of achieving this privatization, but one that, despite its attraction to economists, does not find much favor in the legal fraternity.[195]

SUMMARY AND CONCLUSION

The contention of this paper is that remedies for breach of contract are not now entirely consistent with the goal of economic efficiency. The routine remedy is the awarding of money damages, whereas economic efficiency considerations urge specific performance as the routine remedy. Following Calabresi and Melamed's analysis of legal and equitable remedies in nuisance law, I propose that the efficient exchange of mutually beneficial promises would be better served by using the level of transaction costs as the guide for choosing a contract remedy: if transaction costs are low between the defaulter and the innocent party, then an award of specific performance will encourage the parties to exchange the right to performance voluntarily and efficiently; if, however, those costs are so high that no voluntary exchange can take place, then the court should intervene and compel an exchange at a collectively determined price; that is, the court should award money damages. Since it is most likely to be the case that parties to a contract have low transaction costs in that they, unlike, say, tortfeasors and their victims, have already established a relationship, courts should presume that specific performance is to be awarded, with money damages being the exceptional award. This is precisely the opposite of current practice.

The contention that specific performance will greatly increase administration costs or post-breach negotiations costs has been shown to be inaccurate. By comparison to the award of expectation damages, the court costs of specific performance are much less and much more accurate in protecting the breachee's expectancy. There is no less an incentive to mitigate the innocent party's losses under specific performance than there is under efficient money damages. Nor will consequential damages be inefficiently captured under specific

194. This was the thrust of Professor Rubin's criticism of specific performance. *See* Rubin, *supra* note 36 and accompanying text.

195. FED. R. CIV. P. 53(b) states that the use of a special master "shall be the exception and not the rule." *See* Schwartz, *supra* note 6, at 279-84. *See generally* Brazil, *Referring Discovery Tasks to Special Masters: Is Rule 53 a Source of Authority and Restrictions?*, 83 AM. B. FOUND. RESEARCH J. 143 (1983).

performance where they are efficiently excluded under legal relief. Lastly, there are two valid defenses to an action for specific performance: impossibility of performance and high supervision costs. I have argued, however, that even high supervision costs are not a necessary or sufficient condition for not awarding specific performance. This is because there are factors that lessen the inefficiencies of equitable relief in cases where supervision costs are most likely to be high: *viz.*, the breacher's regard for his reputation and the possibility that it may be more efficient for the parties to bargain out of performance of the contract than to risk high supervision costs, even if those are to be paid out of the public fisc. Additionally, specific performance should be imposed in instances of high supervision costs if, through the use of special masters, the cost of supervision can be shifted to the litigants and away from the public.

Finally, I wish to stress that what has been laid out here is, I believe, a logically consistent hypothesis that specific performance should be the routine contract remedy if the goal of contract law is to promote the economically efficient exchange of mutually beneficial promises. This is, thus far, no more than, I trust, a very persuasive hypothesis. It is not a settled conclusion. It would be overly hasty to reform the law before seeing whether this hypothesis withstands a confrontation with the relevant facts. Among many other things, we need to know the relative transaction costs of court versus private settlement of breached promises and whether contractual behavior would become more efficient if those exchanging promises knew that the routine remedy were specific performance. We need to know what sorts of disputes about contract breach are brought to court: do they concern only particular types of commodities or all types? Are they, for example, goods whose elasticity of supply is low or goods whose cross-price elasticity of demand is low? With regard to awards, what percentage is damages? What percentage is specific performance? Do courts usually award expectation loss, or do they use some other standard, and, if so, why?

The law and economics literature has grown so extensive that it has offered a tremendously important and staggeringly large number of hypotheses. The empirical research agenda in the field is one of the most exciting in all of the social sciences. Given the well-known difficulties involved in working with court records,[196] this empirical work will not be easy. That does not, however, excuse its not going forward. One possibility is a comparison of the disposition of breach of contract

196. *See* Priest & Klein, *supra* note 126, at 2-5.

cases in common law and civil law countries. Another possibility may be to adopt the methods of experimental economics to test the numerous, complex hypotheses about behavior under alternative legal rules.[197]

---

197. For a general survey of the techniques and conclusions of experimental economics, see Smith, *Microeconomic Systems as an Experimental Science,* 72 AM. ECON. REV. 923 (1982). A recent survey of the small and growing literature on the use of experimental techniques in the economic analysis of law is Hoffman & Spritzer, *Experimental Law and Economics: An Introduction,* COLUM. L. REV. (forthcoming). *See also,* for a particular example, Grether, Schwartz & Wilde, *Experimental Tests of Imperfect Information,* California Institute of Technology Social Science Working Paper (1984).