

THE MYTH OF EFFICIENT BREACH: NEW DEFENSES OF THE EXPECTATION INTEREST

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INTRODUCTION

CONTRACT remedies have long sought to protect the gains that parties contract to realize. Although the Restatement recognizes three distinct contractual interests—expectation, reliance, and restitution—it expressly privileges the *expectation interest* over the other two. Courts “[o]rdinarily . . . enforce[] the broken promise by protecting the expectation that the injured party had when he made the contract.”¹

In recent years, both courts and scholars have begun to question *how* the law should protect a promisee’s expectation. This question once had a conventional—indeed, assumed—answer. Courts, the Restatement observes, ordinarily protect the promisee’s expectation “by attempting to put him in as good a position as he would have been in had the contract been performed”;² that is, by “giv[ing] the injured party the ‘benefit of the bargain.’”³ The Uniform Commercial Code similarly recites that contract remedies are designed to put the aggrieved party “in as good a position as if the other party had fully performed.”⁴ Conventional contract law thus does not put the promisee in the position of receiving the promised performance but rather puts him “in as good a position” by requiring the promisor to pay *money damages* that equal the benefit of the promisee’s lost bargain. In the current lexicon, contractual expectations conventionally receive *liability* rather than *property* rule protection.

That contract remedies should vindicate the expectation interest through liability rules has become controversial.⁵ The controversy is best introduced by clarifying basic terms.

¹ The complete statement recites:

Ordinarily, when a court concludes that there has been a breach of contract, it enforces the broken promise by protecting the expectation that the injured party had when he made the contract. It does this by attempting to put him in as good a position as he would have been in had the contract been performed, that is, had there been no breach. The interest protected in this way is called the “expectation interest.”

Restatement (Second) of Contracts § 344 cmt. a (1981).

² *Id.*

³ *Id.*

⁴ U.C.C. § 1-305(a) (2011).

⁵ Among the more prominent critics, see, e.g., Melvin Eisenberg, *The Disgorgement Interest in Contract Law*, 105 Mich. L. Rev. 559, 562 (2006) [hereinafter Eisenberg, *The Disgorgement Interest in Contract Law*]; Melvin Eisenberg, *Actual and Virtual*

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A Liability Rule: The law protects an entitlement by a liability rule when it requires an infringer of the entitlement to pay the entitlement holder a sum of money fixed by a third party, typically a court. Under contract law, the promisee is entitled to the benefit of his bargain, which the promisor infringes by breaching. The law accords liability rule protection to the entitlement because a court or jury fixes the entitlement's value and requires the promisor to pay it as damages.

A Property Rule: The law protects an entitlement with a property rule when it makes the entitlement holder's acquiescence a necessary condition for transfer of the entitlement. Contract law would protect the expectation with a property rule if it required the promisor always to render the promised performance rather than a monetary substitute for it. Under property rule protection, the promisee could obtain specific performance as of right.

Both liability and property rule protection of a contractual expectation focus on the value that the promisee places on performance. Liability rule protection permits the promisor to "take" the entitlement and later pay, or comply with a court order requiring her to pay, the promisee's value. Property rule protection would permit the promisee to enjoin unconsented takings, thereby requiring the promisor to repurchase the entitlement from the promisee.⁶

A Restitutory Rule: In contrast to liability and property rules, a restitutory rule such as disgorgement⁷ focuses on any value the promisor possesses that is attributable to the promisee. The Re-

Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law, 93 Calif. L. Rev. 975, 977-78 (2005) [hereinafter Eisenberg, Actual and Virtual Specific Performance]; Daniel Friedmann, The Efficient Breach Fallacy, 18 J. Legal Stud. 1-2 (1989); Seana Shiffrin, *Could Breach of Contract Be Immoral?*, 107 Mich. L. Rev. 1551, 1565-66 (2009) [hereinafter Shiffrin, *Could Breach of Contract Be Immoral?*]; Seana Shiffrin, The Divergence of Contract and Promise, 120 Harv. L. Rev. 708, 710 (2007) [hereinafter Shiffrin, The Divergence of Contract and Promise]; Richard R. W. Brooks, The Efficient Performance Hypothesis, 116 Yale L.J. 568, 572-73 (2006). We postpone a detailed discussion of the literature to Part III below.

⁶ By "repurchase," we mean that the promisor must pay a sum satisfactory to the promisee for permission not to render the promised performance.

⁷ The disgorgement remedy requires a breaching promisor to pay to the promisee the net monetary gain the promisor realized from breach. Disgorgement is used, for example, when a promisor/seller has sold contract goods to a good faith purchaser for value, so specific performance is rendered unavailable.

statement describes the promisee's restitutionary entitlement as his "interest in having restored to him any benefit that he has conferred on the other party."⁸ This benefit can include gains that the promisor realized from breach if the parties' contract contributed to their existence. A restitutionary rule is enforced by an order requiring the promisor to pay over the value in her hands.

Some critics, including both commentators and courts, argue that contract law should protect the expectation with a property rule. Other (and overlapping) critics support vindicating the restitution interest.⁹ The critics are beginning to have an impact on the positive law.¹⁰ The classical expectation remedy, long a fixed point of contract law, is coming under threat.

This Article rejects both categories of criticism in favor of defending contract law's conventional preference for protecting the expectation interest with a liability rule. Although we defend the (increasingly insecure) status quo, we do so by novel arguments. Novelty matters in this case. The familiar arguments in favor of current law do not quite address the revisionist wave. Our arguments refute the revisionists' claims head-on.

Before introducing these arguments, we make a further clarifying remark concerning renegotiation.¹¹ Renegotiation is unnecessary when contract law protects the expectation with a liability rule. A promisor who rejects performance is required only to pay the promisee's foregone value. She therefore can make value-maximizing perform-or-breach decisions unilaterally. In contrast, parties may renegotiate under property rule or restitution protection. Promisor exit from a contract may, we show below, create a greater total gain than performance. In this event, a promisee with property rule protection has an incentive to renegotiate to a new arrangement, under which the promisor is permitted to exit in return for sharing with the promisee the larger gain that exit makes possible. Restitution protection permits the promisee to capture

⁸ Restatement (Second) of Contracts § 344(c) (1981).

⁹ See authorities cited *supra* note 5 and discussion *infra* note 18 and accompanying text.

¹⁰ See *infra* notes 18–19 and accompanying text.

¹¹ In contract theory, parties renegotiate when they jointly alter contractual entitlements after they learn the true state of the world. For example, parties may agree to raise or lower the price when they learn the seller's actual cost of performance.

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the gain that exit from a contract can create. The promisor, however, can prevent this gain from coming into existence by performing. Hence, the promisee, again, has an incentive to permit promisor exit in return for a share of the gain. Though the restitution remedy and property rule protection of the expectation focus differently on the location of the gains from breach, the availability of renegotiation causes the two rules to generate the same payoffs for contracting parties. Recognizing this permits us, for convenience, to evaluate the expectation interest debate primarily by contrasting liability and property rules.¹²

Taken together, these clarifications permit us now to state the core of our position: both the efficient administration of commercial exchange and the commercial morality of the exchange relation require that promisors' obligations be set according to *promisees' gains from trade* and that these obligations be vindicated by a mechanism in which *courts assess the gains' monetary value*. That is, contract law should retain its traditional commitment to vindicating the promisee's expectation interest and should protect this interest by a liability rule. But we should not get ahead of ourselves. Rather, we begin at the beginning, by rehearsing conventional defenses of contract law's decision to protect the expectation interest with a liability rule, in order to establish the background against which recent critics have attacked the law and against which we construct our novel defenses.

Contract remedies took their liability rule form many years ago, but until recently, the law lacked a theoretical justification. In the 1970s, law and economics scholars constructed an efficiency rationale that ranges over the three stages of a contractual relationship. Beginning at the last litigation stage, a court cannot protect the expectation unless it is informed of the promisee's gain: the value a

¹² When we care not just about the parties' payoffs but also about the conceptual categories under which the payoffs are produced, we say so expressly. Part III analyzes the theoretical relation between restitution- and expectation-based justifications for protecting promisee interests. Note that property and restitutionary rules would diverge in practice as well as in theory if the promisee could *require* the promisor to breach so as to bring a breach gain into existence. Under restitution protection, the promisee would then be entitled to all of that gain. Richard R.W. Brooks, *supra* note 5, makes a breach-forcing proposal, which we criticize below. See *infra* Subsection III.B.2.

buyer would have realized¹³ or the cost the seller would have incurred.¹⁴ Parties inform courts, which makes the penultimate stage relevant. Then, the parties learn values and costs and make the performance/breach decision. Now let a seller, for example, discover an opportunity to sell to a third party or to redeploy her resources to some entirely distinct purpose, rather than perform under the initial contract. As long as the law requires the seller to pay the promisee's gain if she breaches, she will perform nevertheless unless her gain from breach would exceed the promisee's gain from performance. Protecting the expectation with a liability rule thus is *ex post* (that is, at the performance/breach stage) efficient. A promisor breaches only if breach would produce a greater gain overall than performance would have done; otherwise, she performs. Now turn to the initial, contracting stage. Parties would contract for liability rule protection of the expectation because this would maximize the expected contracting gain for the parties to share. This multi-stage justification for liability rule protection has a name—the “theory of efficient breach”—and it has become sufficiently familiar to appear in textbooks intended for students.¹⁵

The theory of efficient breach is vacuous, however. To see why, focus initially on the penultimate stage, when the promisor decides whether to perform. The Coase Theorem teaches that when transaction costs are low and agents are informed, as in contracting situations, agents bargain to the efficient allocation of property rights if the status quo allocation is suboptimal. To apply the Theorem here, let the law protect the expectation with a property rule—specific performance—and assume that performance of the parties' original contract would be inefficient: the promisor's loss from performance would exceed the promisee's gain. In this circumstance, as just said, parties renegotiate to permit breach: that is, they renegotiate to the result that a liability rule would have yielded on its own. Now let a liability rule obtain and assume that performance would be efficient: the promisee's performance gain exceeds the promisor's performance loss. In this circumstance, the promisor performs, which is the result that a property rule would have di-

¹³ The law awards the buyer his value less the price.

¹⁴ The law awards the seller the price less her cost.

¹⁵ See Jeff Ferriell, *Understanding Contracts* 715–17 (2d ed. 2009); Robert A. Hillman, *Principles of Contract Law* 140–41 (2d ed. 2009).

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rected. And to summarize, in the Coase Theorem environment that efficient breach theory assumes, efficient breach (and efficient performance) occurs under every rule type.

Efficient breach theory also fails at the contracting stage because it cannot explain why parties would agree to liability rule protection were they free to do so. If parties ex post capture the surplus that breach makes available under any remedy, all remedies are consistent with surplus maximization. The theory thus cannot show why parties would contract for any remedy in the feasible set rather than any other remedy. Indeed, liability rule protection appears particularly problematic from a contracting point of view. The remedy allocates the full gain from breach to the promisor, so the promisee apparently has no reason to agree to it. The morality of promising, furthermore, seems to vindicate the promisee's concern. Even when breach is efficient, a breaching promisor appears to disappoint his promisee and violate his contractual obligations. The expectation remedy, however, apparently permits the promisor to retain the gains from her breach. Efficiency is not generally regarded as a sufficient ground for the law to permit, and indeed encourage, such an apparent wrong. There are no analogous doctrines of efficient conversion or efficient theft, for example.

There are two ways to rescue liability rule protection of the expectation interest from this theoretical lacuna. First, transaction costs may be lower under a liability rule. Second, the remedy may better encourage the parties to invest in the deal their contract is meant to protect. Under either explanation, protecting the expectation with a liability rule increases net surplus and so permits the promisor to purchase the promisee's consent to the remedy. We later pursue the transaction cost idea, but it is important to note here that *both* explanations relax the two key assumptions that generate efficient breach theory. The first assumption is that transaction costs are zero (that is, contracting and renegotiation are costless). The second assumption is that parties do not invest in the contract.¹⁶ When these assumptions hold, however, the remedy is theoretically ungrounded.

¹⁶To clarify, investment can be "general" or "relation specific." A seller makes a general investment when she builds a factory to make widgets and sells them to a wide variety of buyers. A seller makes a relation-specific investment when she produces a customized widget that only a particular buyer can use. Efficient breach the-

In recent years, prominent critics, implicitly accepting the two assumptions that generate efficient breach theory, have stepped into the void to argue that the expectation interest remedy is the wrong rule. The critics make two related claims. First, they claim that liability rule protection of the expectation interest is unjust because it allocates the full gain from breach to the promisor. This claim assumes the promisee has a right to share in the gain that breach makes possible. The critics' second claim defends this assumption. According to the critics, a contract law that permits an agent to bind herself to perform *but also* permits the agent to breach if she pays a legally set price—the expectation—is incoherent. A law of contract must permit agents to bind themselves. Hence, the law is made coherent only if it protects the promisee's right to performance with a property rule. The default contract remedy thus should be specific performance. The analysis above illustrates how the critics' two claims are related. A promisee with a right to specific performance can capture a portion of the gain that breach makes possible by forcing the promisor to purchase the right to exit from the contract.¹⁷

A legal rule whose theoretical foundation is shaky sometimes is replaced, so it is unsurprising that the expectation interest's critics have made real world progress. The Uniform Commercial Code liberalized the right to specific performance. Specific performance, however, sometimes is impractical: it takes too long to get. Specific performance also is impossible when the promisor has sold the property to a good faith purchaser. The disgorgement remedy ameliorates these difficulties because it requires the promisor to transfer her gain from breach to the promisee. The recently adopted Restatement of Restitution permits a court to replace the expectation remedy with disgorgement when the remedy is inadequate,¹⁸

ory is consistent with encouraging relation specific investment, but its putative contribution is to explain why liability rule protection yields ex post efficiency.

¹⁷ The restitution rule rests on the premise that the contract creates a right in the promisee to the potential gain from breach. This right grounds the promisee's distributional claim because it is unjust, on the restitution theory, to deprive him of the actual gain.

¹⁸ Restatement (Third) of Restitution and Unjust Enrichment § 39(1) (2011). A thoughtful analysis by the drafter appears in Andrew Kull, Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts, 79 *Tex. L. Rev.* 2021, 2028–29 (2001).

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and “gain based damages” are beginning to be awarded in England and Israel.¹⁹ American courts also increasingly exhibit distaste for restricting contract damages to the promisee’s loss when the promisor benefitted from breach.²⁰ Critics also argue that the promisee’s right to performance sometimes should be protected with the strongest remedy: punitive damages.²¹

This Article thus enters an academic debate—Can liability rule protection of the expectation interest be justified?—that has real world consequences. Much in contract law will change if the critics’

¹⁹ For England, see Ralph Cunnington, *The Assessment of Gain-Based Damages for Breach of Contract*, 71 *Mod. L. Rev.* 559–60 (2008). For Israel, see *Adras Building Material Ltd. v. Harlow & Jones GmbH*, 3 *Restitution L. Rev.* 235, 240, 242, 246, 249, 261, 268 (1995). *Adras* is criticized in Andrew Botterell, *Contractual Performance, Corrective Justice, and Disgorgement for Breach of Contract*, 19 *Legal Theory* 135, 154–55 (2010).

²⁰ Traditionally, disgorgement remedies were awarded only in narrow classes of cases. For example, disgorgement might be awarded in cases in which the breaching party violated a fiduciary or quasi-fiduciary duty owed to the victim of the breach. See, e.g., *Snepp v. United States*, 444 U.S. 507, 515–16 (1980) (awarding the CIA disgorgement of profits earned by a former agent in connection with a tell-all book published without being vetted as required by his contract of employment with the CIA); *X-It Prods., L.L.C. v. Walter Kidde Portable Equip., Inc.*, 155 F. Supp. 2d 577, 658 (E.D. Va. 2001) (observing that “equitable remedies,” including disgorgement, may be awarded in cases of “wrongfully obtained profits in a variety of contexts, including breach of fiduciary obligation or breach of contract” but suggesting that the proper award of these remedies depends on a factual finding of “unclean hands”); *Ajaxo Inc. v. E*Trade Grp., Inc.*, 37 Cal. Rptr. 3d 221, 248 (Cal. Ct. App. 2005) (awarding a disgorgement remedy in connection with breach of a nondisclosure agreement governing trade secrets or proprietary confidential information). Another narrow class of cases in which disgorgement remedies have historically been awarded concerns breaches of contract to sell land, where courts, when they are unable to adopt the traditional specific performance remedy for technical reasons, have imposed constructive trusts on breaching sellers and required them to disgorge their gains from breach. See, e.g., *Gassner v. Lockett*, 101 So. 2d 33, 34 (Fla. 1958) (imposing a constructive trust against a breaching seller where a new buyer’s recording of title prevented the court from ordering specific performance of the sale to the buyer against whom the seller breached).

Recently, there has been a trend towards looking more favorably on disgorgement remedies in connection with ordinary breaches of contract. See *EarthInfo, Inc. v. Hydrosphere Res. Consultants, Inc.*, 900 P.2d 113, 119–20 (Colo. 1995) (approving restitution for breach of contract where a defendant’s wrongdoing leads directly to her profits); see also *Univ. of Colo. Found., Inc. v. Am. Cyanamid Co.*, 342 F.3d 1298, 1311 (Fed. Cir. 2003) (recognizing *EarthInfo* as stating Colorado law); *Dastgheib v. Genentech, Inc.*, 438 F. Supp. 2d 546, 552 (E.D. Pa. 2006) (approving of disgorgement in *EarthInfo*-type situations); *Daily v. Gusto Records, Inc.*, No. 3:94-1090, 2000 U.S. Dist. LEXIS 22537, at *6 (M.D. Tenn. Mar. 31, 2000) (endorsing the *EarthInfo* logic).

²¹ See *infra* note 45 and accompanying text.

position captures the day. The changes, we argue here, would be for the worse, both economically and morally.

Our argument rests on an old idea, to which we give a new name: the “dual performance hypothesis.” The dual performance hypothesis justifies protecting the expectation with a damage remedy. The hypothesis holds that contracts typically impose alternative obligations on the promisor: *either* to supply goods or services for a specified price *or* to transfer to the promisee the gain the promisee would have made had those goods or services been supplied. Under the hypothesis, a promisor who fails to deliver the promised goods or services but instead transfers the gain to her promisee *performs* rather than breaches.²² The promisor breaches only if she *neither delivers nor pays*. A breach in this sense contradicts the promisee’s actual expectation—to receive goods or money—and thus reduces agents’ incentives to organize their economic affairs under contracts. On this view, “efficient breach” the-

²² We attempt to advance Richard Craswell’s insight regarding expectation damages that “the equivalent of the promised performance itself depends on the full and exact scope of what was promised—including the exact scope of what was promised in the event of a breach.” Richard Craswell, *Expectation Damages and Contract Theory Revisited* 12 (Stanford Law Sch. John M. Olin Program in Law & Econ., Working Paper No. 325, 2006); see also *id.* at 20–21; Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 *Mich. L. Rev.* 489, 513 (1989) [hereinafter Craswell, *Philosophy of Promising*]. We would substitute a phrase such as “the failure to tender the goods” for “breach.” Our claim then is that the promisee receives “the equivalent of the promised performance” when the promisor makes a monetary transfer that equals the promisee’s gain from trade. This transfer is “the exact scope of what was promised in the event” that the promisor does not tender. We note, moreover, that this conceptual recharacterization of the expectation remedy, which is developed in greater detail in Part III below, also answers Craswell’s famous challenge that philosophical arguments have been unable to explain “those parts of contract law that govern the proper remedies for breach.” See Craswell, *Philosophy of Promising*, *supra* at 517–21.

Our view is beginning to be recognized in the economics literature. Bentley MacLeod defines a “warranty contract” as what we later call the “liability rule contract”: the buyer agrees to pay the price for a good that conforms to the contract and the seller agrees to make a transfer if the good does not conform. MacLeod remarks: “Observe that, under a warranty contract, the production of a defective good *does not* result in a breach of contract. Only if the seller refuses to compensate the buyer is there a breach.” W. Bentley MacLeod, *Reputations, Relationships, and Contract Enforcement*, 45 *J. Econ. Literature* 595, 602 (2007); see also Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 *J.L. Econ. & Org.* 381, 401 (1990).

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ory not only is vacuous; “efficient breach” itself is a myth, because no true breach is efficient.

Contract theorists of both an economic and a philosophical bent commonly either ignore the dual performance hypothesis or reject it as being psychologically and perhaps also ethically implausible.²³

²³ Thomas Scanlon’s views are typical of those who fail even to consider the dual performance hypothesis:

Suppose . . . that I have promised to sell you my house . . . that I could get more money by breaking my promise and selling that house to someone else is not a sufficient reason to do that. . . . At a more fundamental level, . . . what *made* my action wrong was not the fact that I acted for a bad (selfish) reason, but rather the fact that I had promised to sell you the house. . . . What makes it wrong . . . to sell to the second potential buyer is that I promised to sell to the first one.

Thomas Scanlon, *Moral Dimensions: Permissibility, Meaning, Blame* 23–24 (2008).

Scholars who do acknowledge the hypothesis have been rejecting it for a long time. Frederick Pollock wrote, in 1881, that

[a] man who bespeaks a coat of his tailor will scarcely be persuaded that he is only betting with the tailor that such a coat will not be made and delivered to him within a certain time. What he wants and means to have is the coat, not an insurance against not having the coat.

Frederick Pollock, *Principles of Contract*, at xix (London, Stevens & Sons rev. 3d ed. 1881). For a modern view, see, among others, Stephen Smith, who claims: “It just seems implausible, as a matter of fact, to regard contracting parties as having agreed, in the typical case, to disjunctive obligations to perform or compensate.” Stephen A. Smith, *Contract Theory* 402 (2004). Also: “[I]t is clear that there is a legal duty to perform a contract and . . . this duty is not fulfilled by paying damages.” Stephen A. Smith, *The Normativity of Private Law*, 31 *Oxford J. Legal Stud.* 215, 238 (2011). Similarly, Andrew Gold claims that “as a general description of what parties intend, or even as an interpretation of the public meaning of contract language, [the dual performance hypothesis] seems inadequate.” Andrew S. Gold, *A Property Theory of Contract*, 103 *Nw. U. L. Rev.* 1, 54 (2009). Eyal Zamir and Barak Medina take the same view, claiming that “[t]he very use of the terms ‘breach’ and ‘remedies’ attests to the prevailing conception that a contract is not ordinarily an option to perform or pay damages, but rather carries a moral obligation to perform.” Eyal Zamir & Barak Medina, *Law, Economics, and Morality: A Response to Critics* 31 (2011) (unpublished manuscript, on file with the Virginia Law Review Association), available at <http://ssrn.com/abstract=1867186>; see also Eyal Zamir & Barak Medina, *Law, Economics, and Morality* (2010).

Commentators sympathetic to the hypothesis either assert it without development or raise the hypothesis only as a formal possibility. Jody Kraus thus observes: “[T]he efficient breach hypothesis *presumes* that many parties use the remedial default rules of contract to specify a morally acceptable alternative to performance of their promised act instead of writing an explicit alternative promise contract.” Jody S. Kraus, *The Correspondence of Contract and Promise*, 109 *Colum. L. Rev.* 1603, 1638 (2009) (emphasis added). As evidence of Kraus’s observation, Alan Schwartz and Robert Scott assert: “[W]hat contract performance requires is the goods in exchange for the contract price *or* the payment of an appropriate monetary substitute. Thus, the dam-

A promisee, it is said, intends to contract for goods or services; he does not intend to sell an option that permits the promisor either to trade or to pay. Our argument against this view proceeds along two intertwined paths. One path, which is developed in Parts I and II, creates a simple model that rests on the two assumptions remarked above: transaction costs are zero, and parties do not invest. On these assumptions, the model permits us to make three points.

First, a promisee's expected monetary payoff is at least as high under liability rule protection of the expectation as it would be under property rule protection. This result refutes criticisms of current law whose premise is that liability rule protection deprives promisees of the gains that they contracted to realize. To summarize the logic of this result, let the promisor be a seller and define two types of contracting gains. The *trading gain* is the difference between the value the promisee would realize from trade and the promisor's cost of trade.²⁴ The *nontrading gain* is the difference between the cost of trade and the promisee's value.²⁵ When a seller rejects trade, a buyer with a right to specific performance realizes his trading gain and a portion of the nontrading gain. The seller must pay the buyer his trading gain because it is the buyer's expectation, and the seller also must pay the buyer a share of the nontrading gain in the form of a bribe for permitting the seller to exit.

age remedy is itself a part of the contracted-for performance." Alan Schwartz & Robert E. Scott, *Sales Law and the Contracting Process* 389 (2d ed. 1991). Randy Barnett raised the dual performance hypothesis as a possibility in his effort to render the positive law governing personal services contracts consistent with his proposal for "a remedies rule which generally favors specific performance." See Randy Barnett, *Contract Remedies and Inalienable Rights*, in *Philosophy and Law* 179, 198 (Jules Coleman & Ellen Frankel Paul eds., 1987). We attempt to advance the argument by *showing* that parties would write dual performance contracts in the conditions most analysts suppose.

²⁴ To clarify, parties "contract" when they create the deal; parties "trade" when they exchange the specified goods or services for the price. In this paper, parties "transfer" when the promisor pays to the promisee in dollars the contractually specified portion of the trading gain.

²⁵ To illustrate, suppose that the promisee would realize 10 from performance and the promisor's cost would be 6. Then the parties will trade, producing a total gain of 4. We often assume below that parties function in competitive markets. In such markets, price equals cost, so the promisee/buyer would realize the full trading gain of 4. Suppose next that the promisee's value remains 10, but the promisor's cost of performance rises to 15. The failure to trade thus would produce a "gain" of 5: the difference between the avoided promisor cost and the promisee's unrealized value. We denote the saved 5 as the nontrading gain.

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A seller who rejects trade thus incurs a cost that is the *sum* of the trading gain and the bribe. Since prices include costs, the contract price when the buyer's expectation is protected with a property rule reflects both cost categories. Now, substitute the expectation remedy for the buyer's right to specific performance. Competition will then cause the price to fall by the magnitude of the bribe the seller no longer has to pay. Holding the buyer's value fixed, his damages increase as the price falls.²⁶ And since the reduction in price equals the expected bribe, the damages remedy permits the buyer to share in the nontrading gain. The buyer thus does as well when his expectation is protected with a liability rule as when it is protected with a property rule.

This result also shows that the movement to protect the expectation with property rules is as theoretically ungrounded as the efficient breach defense of the expectation. If the promisee's gain under a contract is invariant to the remedy the law supplies to enforce that contract, every remedy is as good as every other remedy.²⁷ We therefore ask here whether promisees have second order reasons for preferring to share in the nontrading gain through the price mechanism—that is, through expectation damages—or to share in that gain through the renegotiation mechanism—that is, through a specific-performance-induced bribe.

The second point the model supports is that contracting and bargaining costs do create such second order reasons. This point is best introduced by assuming that parties are free to write either a "property rule contract" or a "liability rule contract."²⁸ Our first point implies that the promisee's gross payoff would be the same under either contract type. We show below—our second point—that the cost of creating a property rule contract would exceed the

²⁶ Recall that these damages are the buyer's foregone value less the price.

²⁷ Robert Scott and George Triantis make a similar criticism as part of their broader argument that contract damages should reflect the option value of performing or breaching. See Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 *Colum. L. Rev.* 1428, 1429 (2004). We do not take a position here as to their general claim.

²⁸ In this Article, a property rule contract exists either when the parties fail to contract out of property rule protection when the law provides it or when the parties expressly authorize the promisee to obtain specific performance. A liability rule contract either fails to contract out of liability rule protection when the law provides it or when the contract contains a liquidated damage clause.

cost of creating a liability rule contract. Buyers/promisees thus would have an incentive to write liability rule contracts because these generate higher net payoffs. Further, when a promisor/seller rejects trade, the property rule contract forces the parties into a bilateral monopoly. Bargaining in this game is zero sum: every dollar the seller pays to the buyer is a dollar that the seller must lose. The seller's incentive to resist payment is increasing in the size of the payment the buyer seeks. Since, we show, the buyer has a higher ex post payoff under a property rule than under a liability rule, the seller bargains harder, and perhaps less ethically, to avoid paying him under the property rule. Reasoning such as this implies that current law is a better default than a property rule default.²⁹ And the implication vindicates the dual performance hypothesis.

Another implication of the dual performance hypothesis—our third point—is that the distinction between liability and property rule protection of the expectation is artificial. To see why, consider a widespread view that parties have no preferences regarding the remedies that the law provides unless their contract contains an express remedy term, such as a liquidated damages clause. This claim is implausible because parties take prices into account and the price is partly a function of the applicable remedy. When the remedy is viewed as an implied term, contract law necessarily pro-

²⁹ We defend the expectation remedy as a default, not as a mandatory rule. In most jurisdictions, however, current law is mandatory: courts do not enforce contracts for specific performance. See Edward Yorio, *Contract Enforcement: Specific Performance and Injunctions* 439–48 (1989), *supplemented in* Steve Thel, 2009 Cumulative Supplement 233–41. The proposed new U.C.C. Article 2, in § 2-716(1), recommends that courts should enforce specific performance terms in commercial contracts, but no state has adopted this Article, and it is about to be withdrawn. A recently published paper makes two claims regarding the disgorgement remedy: (a) it is awarded frequently and (b) it is an efficient remedy when courts cannot fully protect the promisee's expectation. See Steve Thel & Peter Siegelman, *You Do Have to Keep Your Promises: A Disgorgement Theory of Contract Remedies*, 52 *Wm. & Mary L. Rev.* 1181 (2011). The first claim appears to reflect a recharacterization of the expectation remedy. Thus, market damages—the difference between the contract price and the ex post market price—are thought to protect the expectation. A promisor who sells to a third party at the ex post market price must pay market damages to the promisee. Since these damages equal her gain, Steve Thel and Peter Siegelman classify market damages as a disgorgement remedy. We use the more common classification of these damages here. We do not take up their second claim because our goal is to justify the expectation remedy when it does what it is meant to do. We argue below that parties should be permitted to contract for specific performance or disgorgement but that these should not be the default remedies.

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pects the expectation with a property rule. Under a property rule contract, the seller promises to deliver goods or services unless delivery is impractical. Courts specifically enforce this contract by ordering delivery. Under a liability rule contract, the seller promises to deliver goods or services or make a monetary transfer in the amount of the promisee's foregone gain. Courts specifically enforce this contract by ordering transfer.³⁰ Thus, *every* contracting remedy is a form of specific performance.

The other path along which our argument travels, which is developed in Part III, seeks to connect the structure of surplus sharing that our model identifies to the normative structure of contractual obligation and the principles of promissory morality that contract law implicates. Our argument here involves two claims.

First, the dual performance hypothesis is consistent with the normative structure of contractual obligation. Regarding theory, the dual performance hypothesis restores coherence to contract law. Contract law must permit parties to make binding promises. A law that restricts the promisee to the payment of a preset monetary sum is coherent if the promisor binds herself *either* to deliver goods or services or to pay that preset sum. Moreover, a promisee without a right to the promisor's performance has the same expected payoff, or a higher payoff, than the promisee with that right. Thus, current contract law is as distributionally just as the law that the critics favor. We therefore reject the familiar suggestions that the expectation remedy merely prices, rather than sanctions, breach³¹

³⁰ Contract law views a seller's action for the price as a request to have the price term specifically enforced. Comment 7 to U.C.C. § 2-709 recites: "If the action for the price fails, the seller may nonetheless have proved a case entitling him to damages for non-acceptance." U.C.C. § 2-709 cmt. 7 (2011). Similarly, a buyer's suit for expectation damages, on our account, is a suit specifically to enforce the contract's transfer term. The difference between these cases is that the seller is suing to recover a number that the contract specifies—the price—while the buyer is suing to apply a formula that the contract specifies—value less price. This distinction is without normative significance.

³¹ To make our point clear, the law would "price" breach if it specified what the promisor must pay in order to exit, independently of what the parties would want the promisor to pay. We argue here that the parties would want the promisor to pay the promisee's expectation. As such, the legal remedy is an implied *term*, not a price. Further, we do not reject on moral grounds the position that the law should create a sanction, above the damages the expectation interest remedy implies, for a true breach: the promisor's failure either to trade or to transfer.

and that contract law betrays its own normative commitments when it encourages promisor exit.

Second, the type of sharing associated with the dual performance hypothesis is morally appropriate for promisors and promisees who interact, as they do in contract, at arm's length. In making this argument, we take on the core moral objection to the dual performance hypothesis, which is (roughly) that the expectation remedy encourages promisors to behave, within the promise relation, in a self-interested way that betrays the solidarity that this relation should properly involve. We argue, to the contrary, that the thinner form of promissory solidarity associated with the dual performance hypothesis, in which the terms of contractual sharing are cabined by the parties' contract, is appropriate for commercial transactions in open, cosmopolitan economies.

These claims, like the claims elaborated along our argument's first path, are principally formal or analytic. We develop a representation result: a set of concepts that together characterize the practices, doctrines, and norms of commercial contracting. This result exhibits the surplus-sharing associated with contract doctrine's preference for protecting the expectation with a liability rule and elaborates the meaning of that sharing so as to render it consistent with the solidarity that contractual and promissory norms more generally require. These results thus answer the current criticisms of the expectation remedy because the criticisms themselves are largely formal and analytic.

We conclude this Introduction with two remarks and a methodological observation. First, we analyze commercial transactions. Our paradigm case is an agreement to produce a widget, not an agreement to cook dinner together on Thursday nights. This focus permits us to abstract from the familial and affective claims to which contracts in private circumstances may give rise. It would be a category mistake, for example, to offer \$50 to a friend when circumstances caused you to cancel a dinner date with him. It is not a category mistake for the promisors in our analysis to offer money to promisees when the promisors fail to deliver goods.³²

³² Recent experimental papers elicit the opinions of individual subjects regarding the theory of efficient breach. A common response is that subjects, cast as promisors, would pay more than the promisee's expectation interest when they refuse to perform or that promisees would demand more than their expectation when the promisor fails

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Analyzing commercial transactions also permits us plausibly to assume that parties are competent to make contracts and to renegotiate them when circumstances change. We make this assumption not only for its realism but also for heuristic reasons. Current critiques of contract law implicitly assume full rationality. They do not claim that the law constitutes a trap for the weak-minded but rather that a rational promisor can use the law to deprive her rational promisee of the full nontrading gain. We analyze this core contracting case to show that the concern is misplaced.

Our second introductory remark is that we proceed by making explicit the assumptions that govern the current expectation interest debate and then pursuing their implications. Those assumptions

to comply with a contract's substantive terms. This is taken to exhibit the subjects' view that breaching on payment only of expectation damages is immoral. See, e.g., Tess Wilkinson-Ryan, *Do Liquidated Damages Encourage Breach? A Psychological Experiment*, 108 Mich. L. Rev. 633, 637 (2010); Tess Wilkinson-Ryan & David A. Hoffman, *Breach Is For Suckers*, 63 Vand. L. Rev. 1003, 1004–05, 1013 (2010). These experiments are not relevant to our project for two reasons. First, the subjects are individual persons, not firms. A firm is more likely to exhibit behavior consistent with the maximization of monetary returns than an individual responding to a questionnaire. Second, and of greater significance, the subjects were told that nonperformance was a breach of contract, which assumes what should be argued for. In Wilkinson-Ryan's second paper, subjects were asked to evaluate a scenario in which a contractor performed unsatisfactorily but did not offer compensation. Wilkinson-Ryan & Hoffman, *supra*, at 1014–15. The issue we pursue is whether the promisor would "break the contract" if she failed to deliver but made the transfer that the contract requires. Experimental subjects were not asked this question. See David Baumer & Patricia Marschall, *Willful Breach of Contract for the Sale of Goods: Can the Bane of Business Be an Economic Bonanza?*, 65 Temp. L. Rev. 159, 164 (1992) (conducting a study in which subjects given a questionnaire were told that a "breach" was "deliberate" and "willful"); Tess Wilkinson-Ryan & Jonathan Baron, *Moral Judgment and Moral Heuristics In Breach of Contract*, 6 J. Empirical Legal Stud. 405, 405 (2009) (finding that persons assess the morality of breach partly on the basis of the promisor's intentions). The most recent effort along these lines is Daphna Lewinsohn-Zamir, *The Questionable Efficiency of the Efficient Breach Doctrine*, J. Institutional & Theoretical Econ. (forthcoming 2012). This paper reports an experiment in which Israeli students were asked whether they preferred a performance—the seller "will deliver"—to what we call a liability rule contract. A majority of the subjects understandably preferred performance, but this preference is not germane to the issues analyzed here. See Alan Schwartz, *Comment on Zamir, J. Institutional and Theoretical Econ.* (forthcoming 2012). A recent experimental study suggests that "people have a preference for keeping promises per se." Christoph Vanberg, *Why Do People Keep Their Promises? An Experimental Test of Two Explanations*, 76 *Econometrica* 1467, 1468 (2008). A promise, that is, "creates a contractual *obligation* toward the person to whom it is made." *Id.* at 1476. The question we ask, again, is just what, in commercial contracts, that "obligation" consists in.

hold: (a) parties know the values of the relevant economic parameters; (b) parties know what their contracts do;³³ (c) courts can protect the expectation with either a liability or a property rule because courts: (i) interpret contracts to realize the parties' preferences and (ii) learn the costs and values that trade would have implicated; (d) the parties' contracting and bargaining costs are zero; and (e) parties do not invest in the subject matter of the contract. We make these five assumptions for heuristic purposes: that is, we ask how contract remedies would actually function in the idealized world that current critics inhabit. This analysis permits us to ask whether any remedy becomes preferable to any of the others when that world is made more realistic.³⁴

Finally, our formal model and our more discursive analyses are each constructed with the other in mind (this is why we say that the two paths of our argument are intertwined). The model's account of the structure of contractual sharing is developed to answer conceptual concerns about the relationship between contract remedies and contractual solidarity. And our interpretive engagement with the doctrinal, normative, and moral structure of contract aims to elaborate this structure in light of the instrumental interactions between contracting parties that our model highlights. We return to comment on this marriage between economics and philosophy in our conclusion.

Part I sets out a model of the parties' contracting problem, which Part II then solves. The model performs two functions. First, it shows formally that, on the Coase Theorem assumptions noted above, the promisee's expected return under a contract is invariant to the remedy the law supplies. Second, modeling commercial party preferences permits us to identify the circumstances in which parties prefer the liability rule contract, which permits the promisor either to trade or to transfer, or the circumstances in which parties prefer a property rule contract, which commits the promisor to trade. It is important to identify these circumstances because the

³³ This assumption holds that parties read their contracts and are aware of the relevant defaults.

³⁴ The text later relaxes assumption (c)(ii)—property rule protection of the expectation then becomes desirable—and assumption (d)—liability rule protection then becomes desirable. Note 44 relaxes assumption (e). In an investment world, efficiency sometimes requires penalties to be imposed on breachers.

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search is for the appropriate default remedy. Part III then interprets the model's results to show how they clarify the normative issues that occupy the literature and that are beginning to affect the law.

I. A MODEL OF CONTRACTING

A. An Example

We introduce the model with a simple example that shows intuitively how the promisee does as well under liability rule protection of the expectation interest as under property rule protection, given the assumptions that govern the expectation interest debate. The example, and later model, assume that: (a) a contract that offers the buyer a right to specific performance is enforceable; (b) parties share any renegotiation surplus equally (the seller, that is, has equal bargaining power with any buyer);³⁵ and (c) the market has several sellers. In the example, the product costs the seller 6 to produce. The associated "property rule price" for the product is 8. The seller makes a contract at the price of 8 with an initial buyer, who values the product at 10. This buyer's expectation is value less price: $10 - 8 = 2$. In the interim between making the contract and the performance date, a second buyer approaches the seller to bid 12; this buyer's valuation for the product is 14.³⁶

Social welfare from performing either contract is the buyer's value less the seller's cost (we assume no externalities). Hence, the social gain from performing the initial contract is $W_1 = v_1 - c = 10 - 6 = 4$. Similarly, $W_2 = v_2 - c = 14 - 6 = 8$. The marginal social gain from selling the product to the second buyer rather than the first is $W_2 - W_1 = 8 - 4 = 4$. Society thus prefers the second buyer to get the

³⁵ The equal bargaining power assumption is without loss of generality. Our later results hold for any division of bargaining power.

³⁶ Respecting the realism of this common two buyer example, sales are classified in two polar categories: (a) common values: every potential buyer attaches the same valuation to the object being sold; and (b) independent private values: every potential buyer attaches a different valuation to the object, and each buyer knows only his own valuation. Many objects have both a common and an independent aspect. For example, potential buyers usually attach different valuations to an art object, but the object would have a common value element if buyers have an investment motive. Then the buyers would be predicting the (same) future market price. The example in text assumes that the object has a substantial independent value element, so that it is plausible for potential buyers to value the object differently.

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product. The issue is how the first buyer and the seller allocate between them the additional 2 that the second bid of 12 creates.

We assume initially that the parties' contract grants the initial buyer a right to specific performance for the property rule price of 8. The buyer thus can prevent the seller from trading with the second buyer; the seller must renegotiate to exit. Since the parties now have an additional 2 to share, the seller will pay the initial buyer a total of 3, his contractual expectation of 2 plus the 1 that is the buyer's equal share of the seller's share of the marginal social gain from selling to buyer two. The seller also earns 3, the new price of 12 less her production cost of 6 and less the payment to the buyer of 3.

Now assume that the buyer lacks a right to specific performance. It may seem that sharing will not occur. The seller will pay the buyer his expectation of 2 and trade with the second buyer, realizing a net gain of price less cost less damages, or $12 - 6 - 2 = 4$. The seller, that is, apparently captures all of the new gain that the second bid creates.

To the contrary, sharing also occurs when the buyer lacks property rule protection. The buyer's expected gain in the example is 2 because the buyer is assumed to accept a liability rule contract at the property rule price. Assumption (c) holds that there are other sellers in the market. Any such seller has an incentive to approach the buyer with a liability rule contract priced at 7.50. The potential second seller would make an expected profit of 3.50 at the 7.50 price: bid of 12 from the later buyer less production cost of 6 and less expectation damages paid to the initial buyer of 2.50. The buyer's expectation, were this contract breached, would rise to $10 - 7.50 = 2.50$, which exceeds the gain he would make under the contract the initial seller offered. Hence, the buyer would accept the lower priced liability rule contract.

The market price for a liability rule contract would not be 7.50, however, because sellers would undercut any price above 7. For example, if a seller offered the liability rule contract at the 7.50 price, another seller could attract buyers by charging 7.25.³⁷ The competitive process would stop at 7. To see why, let a seller re-

³⁷ When the price is 7.25, the buyer's expectation is 2.75, so the seller realizes $12 - 6 - 2.75 = 3.25$.

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duce the price for a liability rule contract to 6.50. The buyer's expectation then would be $10 - 6.50 = 3.50$, so the seller would earn $12 - 6 - 3.50 = 2.50$. Recall that the seller could earn 3 under the specific performance contract. Hence, sellers would offer either the property rule contract at a price of 8, earning 3, or the liability rule contract at a price of 7, also earning 3. In sum, the equilibrium contract prices are 7 when the rule (or contract) is damages and 8 when the rule (or contract) is specific performance.

The promisee/buyer's expected payoff also is invariant to the legal remedy. When the buyer has a right to specific performance and the seller rejects trade, the buyer expects to realize his expectation of 2 ($10 - 8$) plus 1 in a renegotiation. When the buyer has a right only to expectation damages, he expects to realize only his contractual expectation, but this now is $10 - 7 = 3$.

This example permits us to identify the mistake that critics of the expectation make. The critics incorrectly believe that the two remedies have different distributional consequences because they implicitly assume that sellers can charge property right prices—8 in the example—for liability rule contracts. The price, however, is a function of the rights the buyer actually has. Therefore, the two remedies have identical distributional consequences. We next generalize this example.

B. An Expectation Interest Model

A risk neutral seller and a risk neutral buyer, functioning in a competitive market, agree to trade an item of personal property.³⁸ We begin with the liability rule contract. This contract contains three sets of terms. The "action terms" describe the item that the parties expect to trade and set out the delivery steps the seller is to take. The "transfer term" specifies what the seller must pay to the buyer if the seller does not deliver the item. The "price term" specifies what the buyer must pay to the seller if the parties trade the item.

After the parties contract, they observe the realization of two random variables: the seller's cost to produce (or acquire) the item and the value the buyer attaches to the item. If the seller chooses

³⁸ The competitive market assumption simplifies analysis. We later relax the assumption to show that our conclusions apply in less competitive environments.

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to trade, she tenders the item and the buyer pays the price. If the seller rejects trade, she pays the sum the contract's transfer term specifies. The timing of the model is as follows:^{t¹}: The state moves by choosing a default transfer term. The state's goal is to enact the term that maximizes parties' gains from trade.

^{t⁰}: The parties contract. At this time, they decide what transfer term to include in their contract.

^{t¹}: The parties observe the seller's cost of complying with the contract's action terms and the value the buyer would derive from performance of those terms.

^{t²}: The seller chooses whether to trade or to transfer. If the seller trades, she tenders the item, and the buyer pays the price. If the seller rejects trade, then (a) the seller transfers to the buyer the sum the contract directs, but (b) if the law were to enforce property rule contracts and the parties were to use one, the parties would renegotiate to share the nontrading gain.

Remedies sometimes are necessary to enforce the contracts we analyze. To see why, let Θ denote the set of possible states of the world that may obtain at ^{t¹}. Partition this set into two subsets: θ_A and θ_T . If the realized state θ that obtains at ^{t¹} is in θ_A , trade is efficient (the buyer's value exceeds the seller's cost); if the realized state θ is in θ_T , trade is inefficient (cost exceeds value). Parties should trade in the θ_A states, but the seller has an incentive to reject trade if her realized cost turns out to be lower than the buyer's value but above the contract price. Similarly, parties should reject trade in the θ_T states, but the buyer would like to compel trade when his value turns out to be below the seller's cost but is above the price. Remedies are necessary to resolve these conflict cases.

Parties know the mean, denoted C , of the distribution of possible values that the seller's realized cost can take. There are two cost categories. First, C can be the mean of possible bids from buyers whose valuations exceed those of the contract buyer. In this case, the seller's opportunity cost of performance is the foregone bid from a buyer with a higher valuation. Second, C can be the mean of possible seller production costs. In this case, the seller's opportunity cost of performance is the foregone saving that not performing would have created. Parties also know the mean, denoted V , of the distribution of possible values that the contract buyer could realize from performance of the contract's action terms. Parties do not

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contract when the buyer's expected value is below the seller's expected cost, so we assume that V exceeds C .

In the efficient ex post state θ_A , the seller's expected cost is assumed to be the low C_L and the buyer's expected θ_A value is assumed to be the high V_H . Thus, at t^0 the expected gain from trading the item is $V_H - C_L$. We sometimes refer to this expected gain as a "surplus" and denote it S_a . Trade is inefficient if the ex post state θ is in θ_T ; then the seller's realized cost exceeds the buyer's realized value. Denote the seller's expected θ_T cost as the high C_H and the buyer's expected θ_T value as the low V_L . Thus, at t^0 the expected "gain" from not trading the item is $S_t = C_H - V_L$. This is the expected saving—the nontrading gain—when the seller rejects inefficient trade. The probability that trade is efficient— $\theta \in \theta_A$ —is denoted β_a ; the probability that trade is inefficient— $\theta \in \theta_T$ —is denoted β_t ; $\beta_a + \beta_t = 1$. The buyer's realized value is denoted v , the seller's realized cost is c , and the contract price is p . Parties make contracts to realize trading gains, not to speculate on future states of the world. Therefore, we assume that parties expect the trading surplus to exceed the nontrading surplus and expect the probability of trade to exceed the probability of not trading.³⁹ We also make two assumptions in addition to the five set out in the Introduction: (f) neither party is liquidity constrained; and (g) parties have equal bargaining power at the renegotiation stage.⁴⁰

II. SHARING THROUGH THE PRICE OR THROUGH A RENEGOTIATION

Part II does three things. First, it shows, consistent with prior analyses, that a principal virtue of liability rule protection of the expectation interest is that it achieves ex post efficiency without renegotiation. This is not a serious plus when renegotiation is costless, as we initially assume, but becomes important later, when we show how transaction costs reduce renegotiation's efficacy. Second, Part II shows that promisees would do no better, on the regnant assumptions, were the law to protect the expectation with a property rule. This showing implies that the property right remedies are no

³⁹ Formally, $S_a > S_t$ and $\beta_a \in [1/2, 1]$.

⁴⁰ We later relax assumption (f) and attempt to motivate assumption (b) (parties know what their contracts do). See *infra* Subsection II.E and II.F.2.

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better grounded theoretically than the expectation remedy. Third, Part II argues that parties prefer the expectation remedy when some of the assumptions that now govern debate are relaxed.

A. An Efficient Transfer Term

The liability rule contract permits the promisor to reject trade if she makes a transfer to the promisee. An efficient transfer term would ensure in expectation that parties trade if and only if the value the buyer realizes from trade exceeds the seller's cost (that is, if $v > c$). Let the state, which moves first, choose a default transfer term, denoted r , that requires the seller to pay the buyer's realized expectation if the seller rejects trade: $r = v - p$. Suppose that the seller's cost turns out to exceed the price. If the parties' contract does not change the legal default, the seller accepts trade if her loss from trading is less than the transfer the default requires her to make. The seller trades, that is, if $c - p < r = v - p$, or if $v > c$, and she rejects trade when $v < c$. Thus, under the default, r , parties realize without renegotiation the higher of the two possible contracting surpluses: the trading gain when trade is efficient; and the nontrading gain when trade is inefficient. A state that chooses damage rules in order to maximize the parties' gains from trade would select the transfer term r as the default unless parties would reject it.

B. Parties' Contracting Preferences⁴¹

The contract price divides a deal's expected surplus according to the parties' bargaining powers. The buyer, we assume, can command α of a transaction's expected surplus, where $0 < \alpha \leq 1$. The price thus awards the seller $1 - \alpha$ of the surplus.⁴² Importantly, bar-

⁴¹ Parties may contract in the cases we analyze if there is no perfect substitute for the seller's performance or to insure themselves against any disruption costs that the failure to trade could cause. Regarding the latter motivation, parties sometimes contract to ensure themselves stable sources of supply rather than risk having to make spot purchases in volatile markets. See Alan Schwartz & Robert E. Scott, Market Damages, Efficient Contracting, and the Economic Waste Fallacy, 108 Colum. L. Rev. 1610, 1643-47 (2008).

⁴² Buyers receive all of the expected surplus in competitive markets. To see why, recall that the buyer realizes his value less the price ($v - p$). In competitive markets, price is competed down to cost. Thus, the buyer actually realizes value less cost ($v - c$), which is the entire surplus. In the model, then, $\alpha = 1$ when the market is competitive and falls as competition declines.

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gaining power is determined exogenously.⁴³ Denote the expected surplus under a contract as Z . Then the bargaining power parameter α divides Z , but since parties cannot affect the magnitude of α , they choose the non-price terms to maximize Z . We have just shown that the transfer term r permits parties always to realize the higher of the two possible contracting gains without renegotiation. Hence, parties would accept r as the legal default transfer term.⁴⁴

C. A Property Rule Contract

A property rule contract, were it enforceable, would contain action terms and a price but lack a transfer term. Rather, the buyer would have a contract right to performance of the action terms. To see how this contract would function, assume that there is no performance right but instead the contract's transfer term requires the seller to pay $r = \infty$ if she rejects trade. The buyer's gain from trade would be $v - p$. The seller can restrict the buyer to this payoff by trading, at a loss of $c - p$. Therefore, the parties would renegotiate to excuse the seller, though r is infinitely large, if the seller can make a transfer to the buyer that gives the buyer a payoff that exceeds his trading payoff and that gives the seller a payoff that is less

⁴³ Bargaining power sometimes is determined structurally, as when a market is competitive. When both parties have bargaining power, we assume the bargaining is Nash: each party's relative bargaining power is a function of the parties' disagreement points and their discount rates. The party who can do better outside of the deal commonly does better in it because the other party cannot persuade her to deal unless he accepts a contract that permits her to beat her outside offer. The more patient party also does better because she can wait longer for a favorable offer. Bargaining power is exogenously determined in these cases because neither party can affect either the value of her counter-party's outside option or the rate at which the counter-party discounts that value.

⁴⁴ Parties do not make relation-specific investments in our model because the law's critics do not consider these investments. The model is consistent with efficient investment incentives, however. When the buyer's value is verifiable, as is assumed in the literature we discuss, contracts can take forms such that the expectation interest remedy—that is, the transfer term r —induces the parties to invest optimally. For reviews and analysis, see MacLeod, *supra* note 22, at 602–03; Susanne Ohlendorf, *Expectation Damages, Divisible Contracts, and Bilateral Investment*, 99 *Am. Econ. Rev.* 1608, 1608 (2009); Alexander Stremitzer, *Standard Breach Remedies, Quality Thresholds, and Cooperative Investments*, 28 *J.L. Econ. & Org.* (forthcoming 2012). When the expectation is not verifiable, penalties sometimes are necessary to induce efficient investment. See Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 *Chi.-Kent L. Rev.* 33, 34–37 (2003).

than her (negative) trading payoff. Any such transfer, x , that would permit the seller to exit thus must satisfy the inequalities $v - p < x < c - p$. The left-hand side of this expression holds that the buyer's payoff from permitting seller exit exceeds his expectation; the right-hand side holds that the seller pays a transfer that is less than the loss she would have incurred by trading. As is apparent, both inequalities cannot be satisfied unless $v < c$ (that is, trade is inefficient).

This analysis supports two conclusions. To understand the first, realize that a promisee with a property right has as much power as a promisee who can enforce a very large transfer term. In both cases, the promisee can impose heavy costs on a promisor who refuses to trade or to pay. Therefore, in both cases, the promisor will either trade or offer the promisee a transfer for permission to avoid trade. No transfer that both parties will accept exists, we have just seen, unless trade would have been inefficient. The promisor thus trades under a property rule contract when trade is efficient and makes a monetary transfer to avoid trade when trade is inefficient, just as promisors do today under liability rule protection of the expectation. The second conclusion is that the buyer's renegotiation payoff under a property rule contract exceeds his trading gain: $x > v - p$.

Before discussing how parties share gains under liability rule and property rule protection of the expectation, we note that these conclusions hold for every type of contract that creates a right in the promisee to performance of a contract's action terms. The buyer's share of the non-trading gain is the same under each of them. The buyer's right, it is sometimes suggested, should be protected by awarding him punitive damages when the seller fails to perform.⁴⁵ We have just shown, however, that a penalty of infinity functions as the specific performance remedy functions. Neither remedy causes the seller to perform inefficiently, and under both she exits by paying to the buyer a sum that is between the buyer's gain from trade and the seller's loss from trade. Similarly, a seller would trade inefficiently if the buyer's disgorgement remedy transferred the full gain from not trading to the buyer; but again the

⁴⁵ E.g., Shiffrin, *The Divergence of Contract and Promise*, supra note 5, at 731, 752-53.

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seller escapes inefficient trade by paying to the buyer a sum that is between the buyer's trading payoff and the seller's disgorgement loss. Invariance among remedies exists because the buyer's payoff from renegotiation is a function of (i) the non-trading gain; (ii) the trading gain; and (iii) the buyer's bargaining power in the renegotiation.⁴⁶ These variables do not vary with the particular remedy the buyer invokes to trigger a renegotiation. Hence, the buyer's payoff is the same under all property rule contracts.

*D. Surplus Sharing and the Buyer's Expected Return**1. Intuition*

A property rule contract gives the buyer bargaining power *ex post* because he can compel the seller to perform. A market gives the buyer bargaining power *ex ante* because he can buy from the seller who offers the best terms. To compare the payoffs that these different forms of bargaining power imply, we assume that the law enforces both contract types. Let a seller offer the liability rule contract, which does not convey a property right, *but* charge the buyer the property rule price. This price permits the seller to recover three categories of expected cost: (a) the seller's cost of trade if the seller trades; (b) the seller's cost of paying the buyer's expectation if the seller rejects trade; and (c) the *additional* cost that the rejecting seller later incurs because she must pay the buyer a share of the non-trading gain in order to exit. Since the payment of this share is a cost, it is reflected in the property rule price.

Liability rule contracts with such property rule prices would not exist in equilibrium, however. Sophisticated buyers anticipate the possibility of two possible gains: one that trade creates and the other that rejecting trade creates. If one seller offered a liability

⁴⁶ The parties' bargaining powers *ex post* differ from their *ex ante* powers because their disagreement points change. The seller, in a renegotiation, can restrict the buyer to his expectation by trading and the buyer may lack immediate access to the market to replace the seller's performance. Hence, both parties have bargaining power later. In the model's terminology, it is $0 < \alpha < 1$ for the buyer and is $1 - \alpha > 0$ for the seller. For convenience, we let $\alpha = 1/2$. For an analysis of how a buyer's bargaining power can fall after making a contract, see Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 J. Legal Stud. 271, 310-11, 316 (1992).

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rule contract at a property rule price, a competing seller could get the business of a sophisticated buyer in either of two ways. First, she can retain the price but offer the buyer a property rule contract, which would permit the buyer to get specific performance or disgorgement. Buyers prefer property rule contracts at property rule prices to liability rule contracts at property rule prices because the property rule contract permits the buyer later actually to acquire a share of the non-trading gain. Second, the putative competitor can offer the liability rule contract at a lower price.

We focus on price reductions. Recall that the property rule price aggregates three cost categories. When a seller charges a property rule price without offering a property right, however, category (c) is a profit, not a cost: it is the buyer's share of the non-trading gain that the buyer actually lacks the power to compel. As the introductory example showed, this profit will be competed away. Another way to put this result is that price equals cost in competitive markets. Hence, price under the liability rule contract aggregates only cost categories (a) and (b) above.

The buyer's expected payoff, therefore, is invariant to the contract type he accepts. Under the property rule contract, the buyer pays a price that includes the buyer's expected share of the non-trading gain, *but* he later recovers back this share in the renegotiation that he is able to force. Under the liability rule contract, the buyer cannot force a renegotiation, *but* the price is lower by the buyer's expected renegotiation share. The value the buyer would realize from the seller's performance is unaffected by the remedy he accepts. It thus follows that the buyer's expected payoff is the same under both contract types. Subsection II.D.2 next sets out this reasoning formally and Subsection II.D.3 uses the analysis to create a better-grounded numerical example. Readers for whom the intuition is sufficient can turn directly to Section II.E, which discusses the results.

2. Analysis

A buyer's expected return is the value he expects the goods to create for him less the price he has to pay. In the model here, the buyer's value is exogenous. For example, his value may be a function of demand for the end product the buyer plans to sell. The contract type the buyer accepts thus can affect his expected return

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only through the remedy it creates and the price. Sellers in competitive markets earn a return on invested capital, which is reflected in their costs, but otherwise earn zero profits. We next solve for the prices under the two contract types on this zero-profit assumption.

The seller's expected return under the property rule contract is:

$$(1) E_S(\pi_{pr}) = \beta_a(p_{pr} - c_L) - \beta_t\{(v_L - p_{pr}) + \alpha[(c_H - p_{pr}) - (v_L - p_{pr})]\}.$$

The first term on the right-hand side of Expression (1) is the seller's expected return from trade: the property rule price, denoted p_{pr} , less the cost the seller incurs in the trading state. The entire term in braces is the payoff the seller must make to the buyer in the non-trading state. The first term in braces is the buyer's non-trading state expectation: his low value less the price. The first bracketed term is the seller's saving from rejecting trade—her high non-trading cost less the price. The second bracketed term is the buyer's expectation, which must be deducted because the seller must pay it, as is reflected in the first term in braces. All of the terms in braces are multiplied by β_t , the probability that the parties do not trade. The bracketed terms also are multiplied by α , the buyer's bargaining power, because those terms reflect the payment the buyer can exact to excuse the seller from trading. The bracketed terms simplify to $c_H - v_L$, which equals S_t , the surplus from not trading. Using this simplification, that $\beta_a + \beta_t = 1$, and letting Expression (1) equal zero to reflect the competitive market assumption, the property rule price is:

$$(2) p_{pr} = \beta_a c_L + \beta_t v_L + \beta_t [\alpha(S_t)].$$

The first two terms in Expression (2) represent the seller's expected cost if the parties trade and the seller's expected cost of paying the buyer's expectation if the parties do not trade. The last term is the expected cost of the bribe the seller must later pay to the buyer in order to avoid trade: that is, the expected value of the non-trading gain the buyer's bargaining power under a property rule contract permits him to capture. This bribe is reflected in the price because it is a cost the seller incurs under the property rule contract.

The seller's expected return under the liability rule contract is:

$$(3) E_S(\pi_{ei}) = \beta_a(p_{ei} - c_L) - \beta_t(v_L - p_{ei}).$$

The first term on the right-hand side is the expected value of the seller's gain from trade: the liability rule contract price, denoted p_{ei} ,

less the seller's cost in the trading state. The second term is the buyer's non-trading state expectation, which the seller must pay when she rejects trade. Letting Expression (3) equal zero, the expectation interest price under the liability rule contract is:

$$(4) p_{ei} = \beta_a c_L + \beta_t v_L.$$

Again, the first two terms reflect the seller's expected trading cost and the seller's expected cost of paying the buyer's expectation. There is no third term, however, because under the liability rule contract the seller need not pay a bribe in order to exit. Comparing Expressions (2) and (4), the equilibrium price under the liability rule contract is lower than the price under the property rule contract by the buyer's expected share of the non-trading gain.

Under the liability rule contract, the buyer expects to realize his value less the liability rule price:

$$(5) E_B(\pi_{ei}) = V - p_{ei}.$$

Under the property rule contract, the buyer expects to realize his value less the property rule price and plus his possible share of the non-trading gain:

$$(6) E_B(\pi_{pr}) = V - p_{pr} + \beta_t(\alpha S_t).$$

The buyer's expected return does not vary with the contract type he accepts: that is, Expression (5) minus Expression (6) equals zero.⁴⁷ Regarding the intuition, the buyer's expected value is the same under both contract types. Hence, in this model, the buyer is indifferent between receiving his value less the low-liability rule price, or receiving his value less the high property rule price but later recovering the difference between the prices in a renegotiation.

Finally, although it is convenient to assume a competitive market in demonstrating this result, the result applies broadly. The model is driven by three factors: (i) the buyer has bargaining power ex post; (ii) the seller can charge a price that at least equals her expected cost; and (iii) the seller's ability to price ex ante is constrained by the existence of other potential suppliers. The first two of these factors hold everywhere and the last holds unless a seller has strong monopoly power. Hence, buyers are indifferent between

⁴⁷ Doing this subtraction, we have $(V - p_{ei}) - (V - p_{pr} + \beta_t(\alpha S_t)) = p_{pr} - p_{ei} - \beta_t(\alpha S_t)$. Recalling that $p_{pr} = p_{ei} + \beta_t(\alpha S_t)$, Expression (5) - Expression (6) = 0.

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the two contract types in workably as well as perfectly competitive environments.⁴⁸

3. An Example

In the example, which uses the competitive market assumption, the seller's cost will be 100 with probability 0.8 and 150 with probability 0.2. Hence, the seller's expected cost is $C = 110$. The buyer's value will be 145 with probability 0.8 and 120 with probability 0.2. Hence, the buyer's expected value, V , is 140. Since $V > C$, the parties contract. The parties trade with probability 0.8 because then the buyer's value is 145 and the seller's cost is 100. The buyer has 50% of the bargaining power if the parties renegotiate. In the model's notation, $c_H = 150$; $c_L = 100$; $v_H = 145$; $v_L = 120$; $\alpha = 0.5$; $\beta_a = 0.8$; and $\beta_t = 0.2$. The surplus if the seller rejects trade is $S_t = c_H - v_L = 30$.

If the parties write a liability rule contract, the price, from Expression (4) above, is $p_{ei} = 0.8(100) + 0.2(120) = 104$. If the parties write a property rule contract, the price, from Expression (2), is $p_{pr} = 0.8(100) + 0.2(120) + 0.2[0.5(30)] = 107$. The buyer's expected gain under the liability rule contract, from Expression (5), is $140 - 104 = 36$. The buyer's expected gain under the property rule contract, from Expression (6), is $140 + 3 - 107 = 36$. The buyer thus is indifferent between agreeing to pay 104 under the liability rule contract but recovering nothing later, or agreeing to pay 107 under the property rule contract but expecting with probability 0.2 to recover 15 back in a later renegotiation. The price adjusts to reflect

⁴⁸ We have verified this reasoning by solving for the contract prices under the assumptions that bargaining power is exogenous and that the seller can price so as to extract a share of the expected surplus from transacting. The price difference again equals $\beta_t[\alpha(S_t)]$. The most common workably competitive environment probably occurs when sellers engage in differentiated goods, Bertrand competition. In such markets, many sellers exist, each of whom differs on a dimension relevant to the buyer. For example, the buyer is purchasing a machine. Seller/manufacturers differ in their ability to match the machine to the buyer's needs. Hence, the seller that the buyer initially picks can capture some of the surplus that the buyer realizes from dealing with her rather than with the buyer's second choice. The phrase "Bertrand" indicates that the sellers compete on price. If the initial seller demands too much of the expected surplus from contracting with her, the buyer will turn to another seller, who would charge less. Competition thus again constrains a seller's bargaining power.

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the contract the buyer accepts, so the buyer makes the same expected gain under both contract types.

*E. Critiques of Contract Law and Surplus Sharing*⁴⁹

It is helpful to review the results before discussing positive critiques. We show: (a) parties trade when trade is efficient and reject trade when it is inefficient under both liability rule protection of the expectation and under every form of property rule protection; and (b) a profit-maximizing promisee, on the analysis so far, would accept either the equilibrium liability rule contract or the equilibrium property rule contract because both contract types generate the same expected gain. It follows that liability rule protection of the expectation cannot be uniquely justified on efficiency or distributional grounds. It also follows that property rule protection cannot be uniquely justified on efficiency or distributional grounds. Analyses must go further.

Before turning to possible “second-order” justifications for preferring one or the other remedy, we consider two criticisms of our conclusions. The first criticism holds that parties focus only on negotiated terms at the contracting stage. Parties necessarily negotiate over the action terms and the price. Promisees have no conscious intention regarding other terms, such as the default remedy term. These become relevant only when a party rejects trade. Sellers facing inattentive promisees have an incentive to offer liability rule contracts at property rule prices, thereby appropriating to themselves the entire non-trading gain.

We rule out this result by assuming that promisees know what their contracts do. We motivate this assumption as follows. There are two types of contracts in our model: the liability rule contract and the property rule contract. The liability rule contract has (a) action terms; (b) a transfer term; and (c) a price. The property rule contract, if enforceable, would have (a) action terms; (b') a grant of a property right; and (c) a price. The price in the liability rule contract is a function of terms (a) and (b); the price in the property rule contract is a function of terms (a) and (b'). A sophisticated promisee would ask what the contract price buys him. He cannot

⁴⁹ We focus here on positive concerns with these critiques. Part III presents a more complete analysis of the moral critiques.

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rationally answer this question without considering *both* the (a) terms and the (b) term. Put more directly, the assumption that parties are sophisticated and the assumption that parties ignore the remedy term are inconsistent.

A more general way to put this point is to recall that every term of U.C.C. Article 2, except those governing good faith and fair dealing, is a default that can be varied “by agreement.” Many of these default terms, such as those regulating remedies, warranties, and offer and acceptance, importantly affect a party’s contracting payoff. Thus, a claim that parties pay attention only to negotiated terms is a claim that commercial parties routinely are unaware of the financial consequences of the contracts they make. Such a claim should be supported by more evidence than now exists.

A better criticism of our model would hold that sophisticated promisees know what their contracts do but claim that there also exist “naive” promisees, who cannot reason as we assume and thus who focus only on prices and negotiated performance terms. If enough naive buyers exist, promisor sellers would maximize profits by exploiting them at the cost of losing the business of the sophisticated buyers. The claim that contract law excludes promisees from sharing in the non-trading gain because the law protects only the promisee’s expectation therefore holds if too few sophisticated buyers exist to compel sellers to charge competitive prices.⁵⁰

It is an open question whether there are enough sophisticated buyers. Most contract theories, including those implicit in arguments that contract law should give promisees a property right in trade, assume that commercial promisees have the ability to choose action terms that are in a promisee’s best interest; for if promisees make irrational choices regarding the contract’s substance, there seems not to be a well-grounded property right to protect. Choos-

⁵⁰ The text uses the phrase “too few” because, when parties do not bargain at the contracting stage, sellers may offer optimal contracts in markets that both sophisticated and naive buyers enter when there are enough sophisticated buyers. See Alan Schwartz, *How Much Irrationality Does the Market Permit?*, 37 *J. Legal Stud.* 131, 131 (2008). Irrationality plays a smaller role when there is *ex ante* bargaining. See John A. List & Daniel L. Millimet, *The Market: Catalyst for Rationality and Filter of Irrationality*, 8 *B.E. J. Econ. Analysis & Pol’y*, no. 1, 2008, at 3, available at <http://www.bepress.com/bejeap/vol8/iss1/art47/> (“[W]e conclude that individual irrationality as measured in our experiment does not unduly influence aggregate efficiency in bilateral bargaining markets.”).

ing the action terms, however, requires forward-looking thinking. A promisee who is looking ahead should realize that trade under a contract is uncertain and thus ask how his contract regulates the no-trade possibility. This reasoning suggests that competition works as explicated above, on the assumptions that the critics make. The issue is empirical, however.

A second criticism is that our “equivalence result” rests on the parties’ ability to renegotiate to the efficient ex post state. This ability, in turn, exists only when parties are symmetrically informed about the relevant economic variables at the renegotiation stage. Contract theory models commonly assume that uncertainty resolves ex post—that symmetric information exists—but it is a separate question how realistic this assumption is. When it fails to hold, which may be often, renegotiation results are indeterminate in general. Analysts thus cannot reject the claim that different remedies can generate different contracting payoffs.

This criticism of the equivalence result is out-of-bounds. A debate about whether contract law should protect the expectation with a liability rule or a property rule presupposes that courts can enforce a liability rule. Courts cannot know more than what parties tell them. Hence, if parties never become symmetrically informed about the cost and value variables, courts cannot award expectation damages.⁵¹ Rather, specific performance is the only implementable remedy.⁵² The expectation *debate* thus is relevant only over the domain in which parties, and hence courts, are symmetrically informed at the renegotiation stage. We assume symmetric information ex post both because sometimes the assumption holds and also because to reject the assumption is to reject the issue.

⁵¹ This statement is too broad because courts can protect the expectation with market damages when thick markets exist: a court can conveniently recover contract and market prices. See Schwartz & Scott, *supra* note 41, at 1663, 1667. The text’s statement holds for the many cases in which implementing a damages remedy requires courts to know values or costs.

⁵² The disgorgement remedy also requires courts to know the economic variables. To see why, consider how disgorgement would work in the example that begins Part II. The seller’s gain from selling to buyer two is the difference between the second buyer’s bid and the contract price. Denote that gain as $g = p_2 - p_1$. Then the buyer’s disgorgement remedy would be $d = (v - p_1) + g$. The first term is the buyer’s contractual expectation (value less price) and the second term is the gain the seller must disgorge. A court could not order disgorgement without knowing v .

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We now turn to the dual performance hypothesis. Our claim is that the dual performance hypothesis is plausible because promisees often prefer sharing through a price reduction to sharing through a property right-induced renegotiation. We next attempt to defend this claim.

F. The Buyer Promisee's Preferences

In the pure world of the model, which reflects the pure world of the critics, the buyer is indifferent between receiving a share of the surplus from rejecting trade in the form of a price reduction under the liability rule contract or in the form of an ex post transfer payment under the property rule contract. We now relax some of the model's assumptions, to argue that sharing through the price would be the more common preference.

1. Ex Ante: Costly Contracting

Critics and supporters of liability rule protection for the expectation commonly assume that contracting is costless. When this unrealistic assumption is relaxed, the liability rule contract becomes more attractive because it is cheaper to create. There are two reasons. To understand the first reason, realize that the cost of creating a contract is increasing in the number of contingencies that the contract requires to govern the parties' behavior.⁵³ The liability rule contract conditions on fewer states of the world than the property rule contract. Under the former contract, the buyer pays the price if the seller trades, and the seller pays the transfer if she does not. Thus, there are two possible payoff relevant states under the liability rule contract: trade or no trade. The property rule contract conditions on as many as six payoff relevant states of the world, of which the first two are trade and no trade. If the seller rejects trade and retains the subject of sale, the buyer is entitled to specific performance; if the seller has sold the subject of sale to a third party, the buyer is entitled to disgorgement. Hence, the property rule

⁵³ For a deeper analysis, see Pierpaolo Battigalli & Giovanni Maggi, Rigidity, Discretion, and the Costs of Writing Contracts, 92 Am. Econ. Rev. 798, 798 (2002); see also Ronald A. Dye, Costly Contract Contingencies, 26 Int'l Econ. Rev. 233, 233 (1985) (focusing on contract cost increasing in the number of contingencies the contract includes).

contract also conditions on the states “sale” or “no sale.” Finally, if the promisor is quantity constrained—she cannot immediately expand output—she may be unable to perform for the promisee because she is performing for another. In this case, specific performance is impossible and disgorgement may be impossible as well (because the seller is not earning a pure profit on the second sale), so the promisee is restricted to damages. Thus, the property rule contract also may condition on the states “disabled” or “not disabled.” In consequence of this last possibility, the contract must have a transfer term, just as the liability rule contract does.

The second reason holds that the pricing problem is more costly to solve under the property rule contract. Comparing Expressions (2) and (4) above, under the liability rule contract the seller, in order to price, must predict her low cost and the buyer’s low value. Under the property rule contract, the seller also must predict the non-trading state gain and the parties’ renegotiation bargaining power shares. Pricing the property rule contract thus is more complex, and so more costly, than pricing the liability rule contract.

To summarize, though the value the buyer receives from trade is independent of contractual form, his net payoff may not be. The property rule contract price will often be higher than the liability rule contract price by the additional cost of writing and pricing the property rule contract. Buyers prefer the liability rule contract when it yields the same payoff as the property rule contract but is cheaper to create.

2. *Ex Post*

The background idea is that parties’ interests change as they move from the *ex ante* to the *ex post* stage. Their interests are harmonious at the contracting stage: they then anticipate that they may realize the relatively large trading gain, and so they share a desire to reach agreement.⁵⁴ The parties’ interests are adverse at the *ex post* stage, however: they know then that they will not trade and that they are engaged in a zero-sum bargaining game. Every

⁵⁴ Recall our assumptions that the probability of trade exceeds the probability of not trading and that the trading gain exceeds the saving from rejecting trade. The parties’ interests are not identical: sellers prefer high prices, for example, and buyers low. But because contracting creates a surplus, the parties play a positive sum game. They share an interest in “getting to yes.”

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dollar that the buyer receives as damages or from a renegotiation is a dollar lost to the seller.

In the model above, the zero-sum nature of the ex post game did not matter because the seller was assumed able to make whatever transfer the contract implied. A seller may become liquidity-constrained after a contract is made, however. Such a seller's reluctance to transfer is increasing in the amount at stake. Under the liability rule contract, the buyer's ex post payoff is $v_L - p_{ei}$, his non-trading state valuation less the liability rule contract price. In the example in Subsection II.D.3, that payoff is $120 - 104 = 16$. Under the property rule contract, the buyer's ex post payoff is $v_L - p_{pr} + \alpha S_t$, the buyer's valuation less the property rule contract price plus the buyer's share of the non-trading gain. In the example above, that payoff is $120 - 107 + 15 = 28$.

The seller's reluctance to pay is heightened when, as sometimes happens, her costs are correlated across contracts. A seller may face bankruptcy if her costs on many contracts turn out to exceed the prices she has charged. Since more dollars are involved under the property rule contract, a seller party to this contract is more likely to fight even harder to avoid her obligations in the correlated cost case. Turning to the contracting stage, parties seldom are aware of their counter-party's complete financial circumstances. Buyers under both contract types thus face risk that their seller will turn out to be liquidity constrained. This risk is lower under the liability rule contract than under the property rule contract because there is less at stake in the no-trade state under the liability rule contract. For this reason also, the buyer is inclined to prefer the liability rule contract.

In addition, the model above assumed that the seller makes a transfer immediately after she rejects trade and that renegotiation occurs instantaneously. In a more realistic framework, the seller has an incentive to delay, and renegotiations take time. The buyer may be disadvantaged by delay if he expected to use the contractual transfer to purchase a substitute or to pay off a lender. Delay is more likely when the buyer requires a renegotiation to be paid. The liability rule contract thus poses a lower delay risk.

To sum up these ex post considerations, a seller who is financially constrained has an incentive to resist payment and all sellers have an incentive to delay payment. Resistance or delay may take

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the form of a claim that the seller made a conforming tender that the buyer unreasonably rejected or that her cost increases were sufficiently material as to make performance impractical or that the buyer was not ready to receive timely delivery. Such strategic behavior is more likely to occur, or be more serious, under the property rule contract. Therefore, *ex ante* and *ex post* considerations would cause many buyers to prefer the liability rule contract if the market offered both contract types.

We summarize the analysis in two Propositions:

- Proposition 1: Current contract law permits a promisee to share in the gain that a promisor's rejection of trade creates just as fully as he could share if he had a property right in the promisor's performance.
- Proposition 2: If contract law were to make liability rule protection of the expectation the default, the typical promisee would let the default stand when the promisee could prove his expectation.⁵⁵

We make two further comments. First, a promisee's gross payoff is the same under either contract type, so parties prefer the contract that yields the highest net payoff. The liability rule contract yields the highest net payoff because it is cheaper to create and to enforce. This analysis supports the dual performance hypothesis. The promisee *prefers* the liability rule contract, under which the promisor may choose whether to perform the contract's action terms or to make a transfer to the promisee in the amount of his expectation. Using the vocabulary of contract, the promisee *agrees* to give the promisor this choice, so that it is not a breach when the promisor exercises the choice in favor of paying money. This is the dual performance hypothesis.

⁵⁵ Proposition 2 is phrased in this way because the expectation remedy is not a default but rather is the only available remedy. Courts will not enforce specific performance contracts and will not enforce liquidated damage clauses that fail reasonably to approximate the expectation. The Proposition follows from the model, which assumes that both contract types are enforceable and argues that buyers commonly would prefer the liability rule contract.

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Second, parties prefer the property rule contract when asymmetric information prevents the promisee from proving his expectation.⁵⁶ Our model assumes that parties observe the expected and the ex post values of the cost and value variables. Importantly, courts also can observe the promisee's ex post value: the gain the promisee would have realized had the parties traded.⁵⁷ A court thus can award the promisee this value less the price when the promisor rejects both trade and transfer. Now suppose that the promisee's realized value is unverifiable. Then the court could not protect his expectation with a liability rule, and this creates an incentive for the promisor to reject both trade and transfer. Parties attempt to solve the verifiability problem today with liquidated damage clauses and suits for specific relief. Courts regulate the former and sometimes deny the latter. Our model shows that, in the asymmetric information case, parties would benefit from the ability to contract for an enforceable property right in the promisor's performance.⁵⁸

III. THE NORMATIVE AND MORAL STRUCTURE OF THE EXPECTATION REMEDY

The model above reveals that the dual performance hypothesis best explains how parties contract. Sellers make promises in the alternative: to provide goods or services to a buyer or to make a monetary transfer to him in lieu of those goods or services. Accordingly, a promisor who voluntarily implements the transfer rather than the action terms does not breach her contract but *performs* it; and a court that orders a recalcitrant promisor to make a

⁵⁶ See supra notes 51–52 and accompanying text.

⁵⁷ This is v_L in the analysis above.

⁵⁸ One of us, in an earlier article, argued that courts should enforce specific performance contracts and that specific performance should be available on demand. Alan Schwartz, *The Case for Specific Performance*, 89 *Yale L.J.* 271, 271, 275–77 (1979). In the modern lexicon, the latter claim held that specific performance should be the default. This claim primarily rested on the argument that (a) expectation damages—value less price—cannot be awarded when value is unverifiable; (b) market damages—the price of a substitute—cannot be awarded when no close substitutes exist; and (c) buyers seek specific performance only when factor (a) or factor (b) obtains. As the text above shows, parties would choose property rule contracts in these cases. When the expectation is verifiable, a case not considered in the Schwartz article, the analysis here shows that the liability rule contract is the better default.

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transfer in the amount of the promisee's expectation actually is providing *direct* rather than substitutionary relief.

Part III applies this understanding of the contractual relationship to defend the expectation remedy, understood in terms of the dual performance hypothesis, against two prominent philosophical criticisms. On the analytic level, which concerns the law's normative structure, critics claim that the expectation remedy prices a breach of contract when the law instead should sanction the breach. Moreover, the legal price is set so low as to encourage breach rather than deter it. The intrinsic normative force of a contract law derives largely from its commitment to the performance of contracts. Hence, the expectation remedy, by its slighting of performance, undermines the very legal order to which it belongs. On the level of morality, which concerns extra-legal ideals to which the law must answer, critics claim that the expectation remedy's slighting of performance violates the moral order governing the promises that contracts typically involve.

As we show above, if promisee sophistication is assumed, the transfer term arises out of the parties' actual intentions and not just out of intentions that it would be rational for them to have or fair to impute to them. The transfer promise, that is, is as real, as much a product of the parties' actual intentions, as the promises that constitute the action and price terms. The transfer promise is memorialized in the liability rule contract through the price term, which fixes the gain to buyers both of trade and of transfer (since the contractual transfer equals the value that trade would have yielded less the price). We are tempted by the view that the transfer promise is express—that given the parties' negotiations, the price term just *is* another type of liquidated damages clause, which fixes transfers by reference to the named price (and its associated promisee surplus). Moreover, and critically, even if the transfer term is not express but rather implied from the price, it is implied *in fact* and not just in law. Part III uses these ideas to reinterpret the expectation remedy along lines that answer the remedy's critics. We show that on our interpretation liability rule protection of the expectation sanctions rather than prices breaches, when a breach is understood as the promisor's failure both to trade and to transfer. Hence, the expectation remedy is consistent with the normative structure of contractual obligation. Moreover, we give the expectation remedy an in-

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terpretation that renders it formally consistent with the morality of promise. Finally, we argue that the style of sharing that the expectation remedy introduces into the contract relation better serves the substantive values associated with the morality of promising than its alternatives, at least for the case of exchanges associated with commercial promises among sophisticated parties interacting at arm's length.

A. The Analytic Claim

Critics of the expectation remedy assert that the remedy is inconsistent with the internal (or, as we sometimes say, immanent) normative structure of contract law. This is an analytic point rather than a moral one because it refers to the norms that arise inside contract rather than to contract's connection to moral values that reside outside of the law. We take up the morality of the expectation remedy in Section III.B below. In this Section, we first set out the leading analytic concerns, and we then show how our reconstruction of the doctrine dissolves them.

Critics argue that liability rule protection of the expectation requires courts to *price* breach rather than *sanction* breach.⁵⁹ Melvin Eisenberg thus remarks of the law's encouragement of refusals to trade: "if you don't wish to take a promised action when it is due, because all things considered you believe that the cost to you of taking the action would exceed the gain to the promisee, *you shouldn't keep the promise.*"⁶⁰ Eisenberg adds that this "is not only an effect of the theory of efficient breach, it is a purpose of the theory."⁶¹ In its self-presentation, the theory of "efficient breach"

⁵⁹ An early version of this claim appears in Friedmann, *supra* note 5, at 1. For more recent treatments of the claim, see Brooks, *supra* note 5, at 591–92; Jody S. Kraus, A Critique of the Efficient Performance Hypothesis, 116 Yale L.J. Pocket Part 423, 423 (2007), <http://www.yalelawjournal.org/the-yale-law-journal-pocket-part/scholarship/a-critique-of-the-efficient-performance-hypothesis>.

⁶⁰ Eisenberg, Actual and Virtual Specific Performance, *supra* note 5, at 1012–13. Eisenberg has forcefully advocated for broader recourse to disgorgement. See Eisenberg, The Disgorgement Interest in Contract Law, *supra* note 5, at 559.

⁶¹ Eisenberg, Actual and Virtual Specific Performance, *supra* note 5, at 1013. Here Eisenberg quotes Robert Birmingham, whose article introducing the idea of efficient breach observed that "[e]ncouragement of repudiation where profitable through elimination of moral content from the contract promise might also be socially desirable." Robert L. Birmingham, Breach of Contract, Damage Measures, and Economic Efficiency, 24 Rutgers L. Rev. 273, 292 (1970).

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encourages the thought, as E. Allan Farnsworth puts it, that “a ‘mere’ breach of contract is not a ‘wrong.’”⁶²

Critics (turning the theory of “efficient breach” against itself) insist that this view is inconsistent with the idea that a contract confers on the promisee a normative power to demand performance. The promisor wrongs the promisee by failing to respect that power. It is this wrong that should be sanctioned, a judgment that is the formal opposite of the expectation remedy’s encouraging attitude towards “efficient breach.” This critical judgment follows from the (erroneous) premise that a contract’s action terms exhaustively characterize the promisor’s obligations. Hence, money damages necessarily are substitutionary relief. It is common to hear critics, pursuing the thought that the phenomenon of “efficient breach” places the expectation remedy at odds with the normative structure of contract, echo approvingly the U.C.C.’s observation that “the essential purpose of a contract between commercial [parties] is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit.”⁶³

The ideas that a promisor who chooses transfer over trade is in breach and that liability rule protection of the expectation encourages efficient breaches have surprising staying power, retaining their hold even on those who appear self-consciously to try to shake them loose.⁶⁴ We now give two examples of prominent com-

⁶² E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 *Yale L.J.* 1339, 1341 (1985).

⁶³ U.C.C. § 2-609 cmt. 1 (2003). A recent example is Eisenberg, *Actual and Virtual Specific Performance*, *supra* note 5, at 1007 n.71. Eisenberg cites an influential treatise on restitution, which claims that “[i]n most contracts, . . . [t]he expectation that deserves protection is the promised performance.” 3 George Palmer, *The Law of Restitution* § 15.9, at 440 (1978). This remark repeats the ambiguity in the U.C.C. comment.

⁶⁴ The modern originator of that theory, Robert Birmingham, introduced the argument for the expectation remedy’s efficiency by writing that “[r]epudiation of obligations should be encouraged where the promisor is able to profit from his default after placing his promisee in as good a position as he would have occupied had performance been rendered.” Birmingham, *supra* note 61, at 284 (emphasis added). And Richard Posner, who has perhaps been the theory of efficient breach’s most prominent promoter, cast the efficiency of the expectation remedy as involving a similar assault on the idea that the law requires contracts to be kept: “If [a promisor’s] profit from breach would . . . exceed the expected profit to the other party from completion of the contract, and if damages are limited to loss of expected profit, there will be an incentive to commit a *breach*. There should be.” Richard Posner, *Economic Analysis*

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mentators who acknowledge that a promisor's voluntary payment of the promisee's trading gain might constitute an alternative form of performance but also, in the same breath, characterize a court order to make the payment as a remedy for breach, not an alternative form of specific performance.⁶⁵ Working through the examples helps to establish a contrast between the traditional theory of efficient breach, which is subject to the analytic objections raised by critics, and the dual performance hypothesis, which is not.

We begin with Holmes's famous suggestion that "[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else."⁶⁶ As he took this view of the positive law, however, Holmes also supposed that his account put contract in tension with morality, which requires that promises be kept. Thus, Holmes's famous remark about contract is sandwiched between less-noticed claims that the suggestion that contracts must be kept represents "the confusion between legal and moral ideas,"⁶⁷ propagated by "those who think it advantageous to get as much ethics into the law as they can."⁶⁸ Holmes's disdain for infusing law with ethics obscures the more important point, namely that Holmes did not follow his doctrinal insight that a contract is merely a legal obligation in the alternative backwards to its source, that the contract itself contains alternative promises, so that making the transfer that the contract requires is a form of performance. Holmes in his letters actually denied holding this view, complaining of "the persistence of the impression that I say

of Law 57 (1st ed. 1972) (emphasis added). The most recent edition of Posner's *Economic Analysis of Law*, though it reflects many changes in the characterization of the expectation remedy's efficiency, retains unchanged the thought that the conduct the remedy encourages, though efficient, involves a breach of contract, and therefore that the remedy itself provides substitutionary relief.

⁶⁵ A similar phenomenon appears in Restatement (Second) of Contracts § 361 cmt. a (1981), which recognizes that a promise in the alternative gives promisors a privilege to transfer rather than to trade but also characterizes the transfer as a breach.

⁶⁶ Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 462 (1897) [hereinafter *Holmes, The Path of the Law*]; see also Oliver Wendell Holmes, *The Common Law* 301 (Boston, Little, Brown & Co. 1881).

⁶⁷ Holmes, *The Path of the Law*, supra note 66, at 462.

⁶⁸ *Id.*

that a man *promises* either X [to trade] or *to pay damages*.”⁶⁹ Instead, Holmes insisted: “I don’t think a man promises to pay damages in contract any more than in tort. He commits an act that makes him liable for them if a certain event does not come to pass, just as his act in tort makes him liable *simpliciter*.”⁷⁰ We embrace the expectation remedy as Holmes did, but reject his view of contracts’ promissory content, and hence also the view that the expectation remedy puts contract law at odds with promissory morality. As we argue in greater detail below, the view that a contract contains two promises entails that the expectation remedy puts as much ethics into legal doctrine as any reasonable alternative.

Steven Shavell also has identified the doctrinal confusion associated with the idea of “efficient breach” only to be drawn back into it. Shavell observes that “because contracts are incomplete, that is, do not explicitly address many contingencies, one cannot automatically say that a person has made a promise to . . . do a particular thing in a problematic contingency even though the contract in a formal sense imposes an obligation to perform.”⁷¹ Moreover, he argues, where the costs to the promisor of performing a contract in an unaddressed contingency exceed the value of performance to the promisee, the parties would not have required performance in that contingency if they had addressed it in their contract.⁷² Finally, Shavell observes: “We can deduce from the fact that the party in breach was willing to pay the expectation measure of damages that [performance would have cost her more than its value to her promisee, so that] . . . the parties likely would not have stipulated performance had they addressed the contingency that arose.”⁷³

Because Shavell believes, plausibly, that “[I]f a contract does not address a contingency, then the moral duty of a party if the contin-

⁶⁹ Letter from Oliver Wendell Holmes to Frederick Pollock (Dec. 11, 1928), in 2 *Holmes-Pollock Letters: The Correspondence of Mr. Justice Holmes and Sir Frederick Pollock, 1874–1932*, at 233 (Mark DeWolfe Howe ed., 1942).

⁷⁰ *Id.*

⁷¹ Steven Shavell, *Specific Performance Versus Damages for Breach of Contract: An Economic Analysis*, 84 *Tex. L. Rev.* 831, 867 (2006). Shavell here distinguishes between a contract that is obligatorily complete and a contract that actually is complete. A contract that contains enough terms—for example, a price and a quantity—for a court to grant a remedy but that does not address “a problematic contingency” is only obligatorily complete.

⁷² Steven Shavell, *Is Breach of Contract Immoral?*, 56 *Emory L.J.* 439, 441 (2006).

⁷³ *Id.*

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gency arises is determined by what the contract would have said had it provided explicitly for the contingency,”⁷⁴ he concludes that the willingness of a promisor to pay expectation damages in a particular contingency implies that she has no moral obligation to perform [the action terms] in that contingency.

Shavell goes on to claim, however, that the failure of the promisor to perform those terms is a breach of contract.⁷⁵ His account of the expectation remedy thus also observes that there is a tension between law and morals in this area, although it is the reverse of the tension on which critics of the positive law base their objections to the expectation remedy.

In spite of this difference, Shavell’s view that the tension exists, like more conventional views, rests on the incorrect premise that a contract that expressly specifies the action terms but not the transfer term legally obligates the promisor to perform specifically the action terms. This is the premise that leads Shavell to characterize the refusal to perform those terms as a breach. The contract that we and Shavell analyze—what we call the liability rule contract—creates two legal obligations, however. Parties prefer a contract that gives the promisor the choice whether to trade or to transfer

⁷⁴ Id. at 443.

⁷⁵ Sometimes, these conflicting views about the promisor’s obligations are expressed almost simultaneously:

In other words, under the expectation measure of damages for breach, the seller will fail to perform in the same contingencies as the seller would be permitted not to perform in a complete contract. Accordingly, breach should not be characterized as immoral under our assumptions.

Id. at 449.

In a footnote to this passage, Shavell asks, “[W]hat if a party breaches an explicit contingent provision of a contract and pays expectation damages?” Id. at 449 n.20. He worries that in this case the breach would be both immoral (because the breached provision is explicit) and not immoral (because the payment shows, the explicit provision to the contrary notwithstanding, that the parties would not have agreed to require action in this contingency). Shavell resolves the “apparent conflict” by wishing it away, claiming that “it cannot happen that a party would be willing to pay expectation damages to breach a truly explicit contingent provision.” Id. He explains away observations of breaches in just such cases as involving various errors: that the expectation remedy is undercompensatory, for example, and so presents promisors with a possibility for opportunism; or that the provision in question has been misunderstood. Id. Our approach is simpler: we observe that a promisor may reasonably reserve for herself the right to pay expectation damages as an alternative form of performance even in contingencies in which, but for this reservation, she would have a primary duty to perform.

because that contract maximizes expected surplus more cheaply than would contracts that confer the trade/no-trade choice on the promisee. As a consequence, if parties were free to contract over remedies, they commonly would accept liability rule protection of the expectation remedy as their default. The tension in Shavell's analysis between law and morals thus dissolves because that tension rests on the incorrect premise that a liability rule contract does not create an obligation that governs in the no-trade contingency.⁷⁶

Shavell's mistake, which others also make, causes him to treat the payment of expectation damages as an *epistemic tool* rather than a *normative feature* of the parties' contractual relation. He thus writes that when the law makes expectation damages the remedy for breach, then "we as onlookers know that when breach occurs, it must be moral, for we can infer that the cost of performance must have been higher than the value of performance from the willingness of the seller to commit breach."⁷⁷ But this suggests that if courts could measure costs and values directly, the expectation remedy might be done away with. Put another way, Shavell's epistemic approach to the expectation remedy cannot justify the view that it is a *remedy*, and so in his analysis expectation damages are an epistemic tool whose use does not rest on a normatively sound foundation.⁷⁸ Our vindication of the dual performance supplies this foundation. When it is recognized that parties permit the promisor to make a transfer of the promisee's trading gain in return for the right not to trade when trading would be inefficient, the analytic criticism of liability rule protection falls.

If expectation damages were merely substitutionary, courts that award them would leave promisees with something other than what they have bargained for, and hence (perhaps) would undermine contract's essential purpose. But because, as we have shown, expectation damages are in fact a species of direct relief—the spe-

⁷⁶ Shavell says, "In committing breach and paying damages, the promisor would be acting in exactly the way called for by a complete contract." Shavell, *supra* note 71, at 867. The promisor acts in this way because the contract actually *is* complete.

⁷⁷ Shavell, *supra* note 72, at 450.

⁷⁸ For a similar argument, see Shiffrin, *Could Breach of Contract Be Immoral*, *supra* note 5, at 1556–59. This is not the only criticism Shiffrin levels against Shavell. Shavell responds to her essay, although not, we believe, to the features of her argument that overlap with ours, in Steven Shavell, *Why Breach of Contract May Not Be Immoral Given the Incompleteness of Contracts*, 107 Mich. L. Rev. 1569, 1570 (2009).

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cific enforcement of a contract's (implicit) transfer term—courts that award them leave promisees with exactly one of the two possible things that they have bargained for.⁷⁹ The expectation remedy, properly understood, therefore is consistent with the widely-held view that promisees bargain for performance, because performance is what the remedy delivers to them. The remedy also is consistent with the U.C.C.'s devotion to vindicating promises with direct relief, and as well with the analytic structure of contractual obligation that this devotion reflects.⁸⁰

⁷⁹ Here it is worth taking up an additional distinction in the margin. Ian Ayres and Gregory Klass rightly observe, in a context related to the current one, that “there are good reasons why promisors want to implicitly say that they intend to perform *simpliciter*, rather than that they intend to perform or pay damages.” Ian Ayres & Gregory Klass, Promissory Fraud Without Breach, 2004 Wis. L. Rev. 507, 513. Ayres and Klass marshal this observation against views, like ours, that understand contractual promises as (implicitly) promises to trade *or* to transfer. But although Ayres and Klass are right to observe that promisors typically intend to act, they do not sufficiently recognize that promisors have two types of intentions: concerning what they intend *to do* and concerning what they intend *to obligate* themselves to do. And while contractual promisors may well (for the good reasons Ayres and Klass report) typically intend to trade, they have equally good reasons to obligate themselves either to trade or to transfer. So Ayres and Klass's accurate observation is not a valid objection to the view of contractual *obligation* that we develop.

We note, finally, that local criticisms aside, our position seems to us friendly to Ayres and Klass's larger project, which, as their title suggests, is to explain how promissory fraud might arise in tort even where there are no violations of contractual obligations (in part because there might not be any contractual obligations to violate). Insofar as contract law focuses specifically on promisors' intentions to obligate, and promisors may have separate intentions concerning what they will do, Ayres and Klass's tort theory fits naturally into a gap that contract necessarily leaves unfilled.

⁸⁰ Jules Coleman recently argued that regarding a promisor's failure to perform a contract's action terms as a breach is consistent with the normative structure of contract, whereas regarding that failure as normatively innocent as long as the promisor performs the transfer term is not consistent. See Jules L. Coleman, Some Reflections on Richard Brooks's “Efficient Performance Hypothesis,” 116 Yale L.J. Pocket Part 416 (2007), <http://yalelawjournal.org/the-yale-law-journal-pocket-part/scholarship/some-reflections-on-richard-brooks%E2%80%99s-%E2%80%9CEfficient-performance-hypothesis%E2%80%9D/>. In Coleman's view, the expectation remedy follows a breach (hence the term “efficient breach”); therefore, the remedy functions as a sanction, remedying an action that the promisor has the capacity but not the right to do. Coleman rejects what he calls the option view—what we call the dual performance hypothesis—because the option view is inconsistent with the basic idea that contracts transfer to promisees the normative power to demand performance. His argument, however, assumes that parties typically make property rule contracts, under which the promisor agrees to perform the action terms unless some traditional ground for excuse obtains. We argue, to the contrary, that the liability rule contract is typical, and under it the promisee has only the power to require the promisor to pay if she refuses

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Our views thus reverse the traditional economic approaches to the expectation remedy whose structure Shavell's arguments lucidly reveal: whereas those approaches assimilate "efficient breach" to the *absence* of an obligation, we assimilate "efficient breach" to an obligation's *performance*; and whereas traditional economic theories of efficient breach understand the expectation remedy as a mechanism for identifying cases in which promisors are not obligated at all, we understand the expectation remedy as the direct enforcement of promisors' contracts. Rather than undermining the immanent normative structure of contractual obligation, the expectation remedy *directly* vindicates that structure.

B. The Morality of Contract: Expectation Damages, the Wrong of Breach, and Contractual Solidarity

Moral criticism of the expectation remedy adds to the *analytic* claim the *moral* claim that encouraging breach is inconsistent with the external-to-law values involved in the morality of *promising*. Principles of fidelity or faithfulness require promisors to do what they say they will do. It follows from this requirement that the promisee has a right to the promised performance. A promisor who pays (expectation) damages in lieu of trade therefore converts her promisee's interest in the contractual performance to her own benefit.⁸¹ Expectation damages, that is, permit a promisor to profit from something that no longer is hers. Specific performance or restitution (its cognate) are appropriate remedies because they, unlike damages, protect the promisee's right to the promised performance.

These views are held by a broad range of commentators including: economists who doubt the moral foundations of the traditional economic analysis of contract remedies,⁸² moralists who agree that the economic characterization of efficient breaches correctly captures the positive law,⁸³ doctrinalists who emphasize that the expect-

to trade. If we are correct in this positive claim, the law's interpretive premise that typical contracts are in the alternative poses no more threat to the normative structure of contract than giving a promisor the right to perform either of any two acts.

⁸¹ See, e.g., Douglas Laycock, *The Death of the Irreparable Injury Rule* 245-60 (1991); Friedmann, *supra* note 5, at 1.

⁸² See Brooks, *supra* note 5, at 573-74.

⁸³ See, e.g., Friedmann, *supra* note 5, at 2.

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tation remedy renders contract law less solicitous of promises than tort law is of owners (there is no general tort doctrine of efficient conversion analogous to the contract doctrine of efficient breach),⁸⁴ and a small but perhaps growing number of courts who have suggested that a promisor who wrongfully breaches should be required to disgorge her gain under the restitutionary principle that a person should not profit from her wrong.⁸⁵

This association between the expectation remedy and a morally permissive approach to promise-breaking is mistaken. That a promisor should be true to her words (and does wrong to break them) does not say what those words achieve: principles of fidelity are not principles of interpretation. The claim that the proceeds created by the rejection of an inefficient trade belong to the promisee or should be returned to him in “restitution” of a wrongful gain is not an independent *argument* for restitution but rather expresses an interpretive *conclusion* about the content of the promisee’s expectations. Part II shows that the interpretive conclusion is incorrect. A promisee can share in the gains from rejecting trade either through the lower price that a contract that permits the promisor to exit on payment of the promisee’s trading gain enables or through the renegotiation that a promisee with a property right can force. In the typical case, the promisee’s expected return from contracting is maximized under contracts that make alternative promises. Promisees thus should be taken to have made such contracts unless the evidence proves otherwise. As a consequence, the default contract does not commit a promisor always to trade but rather to trade or to transfer the promisee’s expectation, an efficient breach is not a true breach, and a promisor who rejects trade is not profiting from a wrong. Seen in this light, the expectation remedy *is* specific performance of the promise to transfer that (as our model shows) contributes as significantly to surplus sharing as the promise to trade. The moral critique of contract damages has yet to refute this view.

⁸⁴ See, e.g., Laycock, *supra* note 81, at 253–54.

⁸⁵ *EarthInfo, Inc. v. Hydrosphere Res. Consultants, Inc.*, 900 P.2d 113, 119 (Colo. 1995).

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1. The Dual Performance Hypothesis and the Wrong of Breach

There is a qualitative difference between a promisor who refuses to trade but voluntarily transfers, on the one hand, and a promisor who declines *both* to trade *and* to transfer on the other. The first promisor keeps her contract and honors her promissory obligation; the second breaches her contract and acts immorally. And when the expectation remedy is ordered by a court (as opposed to being volunteered by the promisor), then it is not just a price but a sanction—a form of redress for this wrong. This analysis raises the question how grave a wrong it is to decline both to trade and to transfer; relatedly, it raises the question whether punitive damages would be an appropriate additional sanction for that wrong.

Parties would not contract for punitive damages and so would reject a punitive damage default in the circumstances modeled here.⁸⁶ The analyses that yield this conclusion, however, assume either that the promisor voluntarily transfers the expectation or that the promisee can costlessly recover it. The latter assumption is obviously false. As a consequence, a promisor who rejects trade may also reject transfer on the impermissible ground that legal costs will deter a promisee's lawsuit. A contract theory approach to remedies is consistent with awarding punitive damages for such bad faith refusals to transfer.

The moral and doctrinal approach to contracts that this Part takes also may support punishing a true breach in bad faith. Our reconstruction of the doctrinal order surrounding the expectation remedy invites a new inquiry into the proper attitude for contract law to take towards true breaches. Far from encouraging breach, the expectation remedy (properly understood) re-emphasizes the seriousness with which the law treats contractual promises—it is an integral part of the law's commitment to enforce such promises (once the promises' contents have been properly understood). That the law takes such breaches seriously enough to remedy the wrong directly, by undoing it (by ensuring that one of the alternatives in the contractual promise to trade or to transfer is performed),

⁸⁶ Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 *Yale L.J.* 369, 372–73 (1990); see Edlin & Schwartz, *supra* note 44 (summarizing the literature).

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makes it natural to ask whether the refusal to perform either alternative merits legal punishment.

The question whether punitive damages are appropriate in the case of true breaches is, on our view, therefore just the standard question, which civil wrongs are sufficiently serious to warrant civil sanction. This is a difficult question even in tort (where the question of punitive damages is allowed to reach a jury only in the case of gross torts). It may be an especially difficult question in connection with breach of contract. Where freedom of contract reigns broadly (and can even set the operational boundaries of good faith and fair dealing), it is difficult to distinguish gross breaches of contract (for example, bad faith breaches) from breaches that violate only the contract itself.⁸⁷ Moreover, mistakes in the direction of awarding punitive damages where none are deserved threaten both impermissibly to punish the innocent and to undermine the predictability of commercial litigation, thereby undoing many of the efficiency gains generated by expectation damages (including of course the gains associated with making the transfers in lieu of inefficient trades that our model identifies).⁸⁸ These concerns require courts to tread carefully. In many jurisdictions, courts decided that they cannot tread carefully enough and so in the end declined to venture forth at all. But if punitive damages for gross breach of contract have had a short career in American law,⁸⁹ this is not because of any principled tension between their moralizing nature and the normative structure of the expectation remedy. Rather,

⁸⁷ This problem is not nearly so difficult in special substantive contexts, for example, situations involving insurance contracts, where the regulated character of the business entails that much less of the arrangement between the parties belongs to the contract and much more to the implied-in-law covenant and where the strategic structure of the interaction makes conduct that constitutes bad faith on any terms more easily identifiable.

⁸⁸ As an example, a promisor may in good faith refuse to trade or to transfer in the belief that the contract, properly interpreted, authorizes her to deliver product A, but the promisee insists that the contract requires the delivery of product B. The law should not deter promisors from raising such interpretive issues.

⁸⁹ Experiments in awarding punitive damages for breach of contract, begun in the 1970s, were ended, and indeed reversed, by the 1990s. A 1998 survey reported that by then thirty-nine American jurisdictions did not allow punitive damages in contract claims unless the plaintiff established an ordinary and independent tort and that only twelve jurisdictions allowed punitive damages in limited circumstances for tortious breach of contract. See William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 *Duke L.J.* 629, 645–47 (1999).

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courts are reluctant to award punitive damages for breach of contract because of pragmatic difficulties that are internal to the effective articulation and administration of a punitive damages regime itself. Again, a liability rule expectation remedy—at least as a formal matter—allows contract law to say all the things concerning breach that moralists about promising wish it to be able to say.

2. *Price Versus Renegotiation Sharing*

The moralist argument against the expectation remedy thus can succeed, if it succeeds at all, not on formal grounds but on *substantive* ones. There is no good substantive argument to make, however, unless contracts contain one promise—to trade—rather than two promises—to trade or to transfer. The substantive arguments implicit in prominent moral criticisms of the expectation remedy fail because they overlook this point.

An extravagant statement of the moral critique appears, for example, in Friedmann's polemical suggestion that the theory of efficient breach is, in principle, equally applicable in the property context, where it leads to the adoption of a theory of "efficient theft" or "efficient conversion."⁹⁰ The analogy works only if a promisee's entitlement to a promise's action terms involves the same form of near-total dominion that characterizes an owner's entitlement concerning her chattels. But the typical promisee has waived the right to such dominance by accepting a contract that creates surplus sharing through the price mechanism.

The idea that the promisee has dominion over the promisor's actions plays an equally central role in the arguments of more modest and deliberate moral critics of the expectation remedy. Like its doctrinal predecessor, this idea exercises a hold over intuitions that draws commentators back in even as they try to shake loose of it. A recent example is Richard Brooks's proposal for replacing "efficient breach" with a remedial regime designed to ensure "efficient performance."⁹¹

Brooks acknowledges "that both supporters and opponents of efficient breach seem to agree that promise-breaking is morally wrong. They just disagree about the nature of the promises made

⁹⁰ Friedmann, *supra* note 5, at 4.

⁹¹ See Brooks, *supra* note 5, at 573.

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in contracts.”⁹² Brooks nevertheless appears to accept the moral critique of the expectation remedy. Thus he supposes that “it would be surprising if, for most people, contractual promises do not share some of the moral imperatives behind promises generally,”⁹³ and he assumes that these are imperatives to trade rather than to trade or to transfer, even going so far as to characterize the latter view (ours) as “morally permissive.”⁹⁴ Indeed, Brooks frames his discussion as an effort to construct a remedy that preserves the efficiency-properties of expectation damages but “is consistent with more robust notions of contractual duty” than those immanent in the expectation remedy; or as he alternatively puts it, to construct a remedy that “can allow for optimal allocation of resources while achieving a higher degree of moral force than the intermediate level associated with efficient breach.”⁹⁵ In all of this, Brooks, like Friedmann, is concerned with preventing promisors from profiting from the moral wrong involved in substituting transfer for trade: “What provokes disapproval of the efficient breach hypothesis,” Brooks says, “are strong moral sentiments that nonperformance of a contractual promise is not a right, but in fact is a wrong, and that promisors should not profit from the unilateral exercise of their power to perform or not.”⁹⁶

Brooks’s efficient performance hypothesis—because it is more carefully elaborated than Friedmann’s accusations concerning “efficient theft”—helpfully illustrates the substantive intuition at the heart of the moral critique of the expectation remedy. In order to square contract remedies with assumed morality, Brooks would give a promisee the right to determine how a promisor conducts herself in respect of a contract’s action terms. Thus, he would make specific performance the standard remedy for breach of contract and allow a promisee who forgoes specific performance to force his promisor to disgorge any gains that the promisor’s rejection of

⁹² Id. at 588.

⁹³ Id. at 590.

⁹⁴ Id. at 590–91.

⁹⁵ Id. at 573–74.

⁹⁶ Id. at 572–73. Courts have in recent years increasingly made similar noises. As one prominent decision observes, at least where “the defendant’s wrongdoing is intentional or substantial,” the wrongdoer should not be allowed to retain the fruits of her wrong. *EarthInfo, Inc. v. Hydrosphere Res. Consultants, Inc.*, 900 P.2d 113, 119 (Colo. 1995).

trade created. Indeed, Brooks's remedy must give the promisee not just an entitlement to the benefits of a promisor's management of her actions but also an entitlement actually to control the promisor's actions. This control includes forcing the promisor to "breach" and then to "disgorge" even when the promisor wishes to "perform" (in our terms, to transfer though the promisor prefers trade).⁹⁷ Together, the two prongs of the efficient performance remedy secure the promisee's dominion over his promisor's actions regarding the contract. Brooks thus has constructed a mirror image of the expectation remedy, which like that more familiar remedy, requires a party to internalize the full social costs of his choice regarding how to dispose of a contracted-for action. (The expectation remedy makes promisors choose between the costs of action to themselves and the costs of non-action to their promisees; Brooks's remedy makes promisees choose between the costs of non-action to themselves and the (opportunity) costs of action to their promisors.) This is the central insight of Brooks's argument concerning economic efficiency.

It is unclear whether this argument can apply to actual cases. A promisee who requires as much control over his promisor's actions as Brooks supposes is likely already to have bought the promisor.⁹⁸

⁹⁷ Brooks is unclear as to whether he endorses this feature of his remedy-regime. He backs away from the suggestion at a critical juncture, recognizing that "[i]t may seem a little odd to think of promisees forcing promisors to breach their promises and then making them pay for the breach (and, indeed, there is extensive case law discouraging the practice of induced breach)." Brooks, *supra* note 5, at 582. Moreover, he suggests in a footnote that his remedy does not, strictly speaking, give the promisee a pure option on his promisor's performance but instead involves a "Dual Chooser Rule, whereby the promisor's initial action (choice) can trigger the promisee's . . . option." *Id.* at 582 n.30. But Brooks, in the very next sentences, hedges his hedge and suggests that the idea of promisee choice is "not so strange." *Id.* at 582. In any event, the efficiency claims that form the core of Brooks's argument leave him structurally committed to the unfettered promisee choice that the main text analyzes. As Jody Kraus has pointed out, Kraus, *supra* note 59, at 427–28, the symmetry between Brooks's remedy and the expectation remedy, and therefore the chooser-cost-internalization that is necessary for Brooks's claims concerning efficiency to get off the ground, will be achieved only if promisees may force promisors to "breach" and "disgorge" in the manner that we describe.

⁹⁸ Recall that the parties that contract theory analyzes often are firms. We briefly expand the text's point in the following way: Brooks's cost-internalization claim holds only if the promisee has a right to exercise control over his promisor's conduct in respect of the contract's trade terms. Brooks's remedy thus makes promisees into the managers—with full rights to exercise command and control—of their promisors' con-

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For the moment, however, we are more concerned with explaining that Brooks's remedy and the expectation remedy are *equally one-sided*: they equally imagine that control over contractual trade is vested unilaterally in a purely self-interested party; and they differ as to which party this should be. Brooks's remedy imports no more cooperation—no greater promissory solidarity—into the ex post contract relation than do expectation damages. Moreover, Brooks's unilateralism seems to us less attuned to the folk understandings of the promise relation than the opposite unilateralism associated with the expectation remedy. But in a way this is beside the present point, because whatever the facts concerning folk understandings turn out to be, it runs counter to the central place that freedom occupies in the morality of promising to insist—as Friedmann, Brooks, and other moralist critics of the expectation remedy do insist—that promissory morality *requires* that ex post control be allocated unilaterally to promisees even where (in the pursuit of their joint interests) promisors and promisees have agreed otherwise. And our model shows that the parties to ordinary commercial contracts—because of the way they share surplus in both the trade and transfer states—will typically reach just this agreement.

tractually promised actions. Speaking loosely, under the regime Brooks proposes, promisees in effect become owners of their promisors' businesses in respect of a contract's trade terms. This way of speaking invokes the Coasean theory of the firm, according to which the firm boundary—the boundary between coordination through ownership and managerial control and coordination by contract—is fixed by the balance between the transaction costs of each coordinating mechanism. See Ronald Coase, *The Nature of the Firm*, in *The Firm, The Market, and the Law* 33, 43–44 (1988). But if the balance of these transaction costs really did make it efficient, as Brooks's remedy supposes, for promisees to exercise managerial control over their promisors' actions, those actions would already fall within the promisees' firms, so there would be no need for the contracts that Brooks's remedy seeks to vindicate. Put simply, where the allocation of discretion and control associated with Brooks's remedy really is efficient, there will be no separate legal entities to begin with and hence no contracts. The expectation remedy produces efficiency across the firm boundary, and Brooks's regime is, in effect, a re-description of efficient decision-making procedures within it. This argument puts in an industrial organization context our contract argument that parties commonly prefer to share through prices, which assume the existence of independent firms, rather than through property right renegotiations, which threaten to collapse firm boundaries.

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3. *The Limits of Contractual Solidarity*

These remarks concerning contractual solidarity lead to the final moral criticism of the expectation remedy that we consider. Unlike the arguments advanced by Friedmann and Brooks, which invoke moral intuitions concerning how to adjudicate the *competition* between promisors and promisees, this criticism invokes a moral ideal of promissory *solidarity*, according to which promises (and hence also contracts) achieve their moral value by replacing, or at least dampening, this competition in favor of a more cooperative contractual relation. On this account, the moral value of promises lies in the sharing of realized gains and losses that promises can involve. One of the basic, formal features of promising is that a promisor makes the promisee distinctive for her—she takes the promisee out of the general sea of humanity and becomes particularly attentive to the promisee's person. As Joseph Raz observed, promises establish a special relationship between promisors and promisees, and the value of this special relationship plausibly explains why it is not a sufficient reason for breaking a promise that doing so is best overall.⁹⁹ Perhaps, then, the unilateralism associated with the expectation remedy wrongly eliminates such promissory solidarity, while other remedies (including, but not limited to, traditional specific performance) might make better room for it.

This moral position is implausible if the sharing that it contemplates occurs as sharing occurs in our model. There, parties to the liability rule contract predict what later sharing requires of them, and they adjust the price to reflect their expected shares. Parties to a property rule contract share *ex post* but not in a way that is more other-regarding or solidaristic than sharing through a price reduction: sharing *ex post* is the product of a competitive renegotiation among self-interested parties bound to each other in a bilateral monopoly as a result of the contract they made.

But contractual sharing *ex post* may arise in another context also—in which the parties to a contract abandon, or at least constrain, self-interested behavior within the contractual relation and instead cooperate in pursuing a fair balance of their interests. This

⁹⁹ See Joseph Raz, Promises and Obligations, *in* *Law, Morality, and Society: Essays in Honour of H.L.A. Hart* 210, 227–28 (Peter Michael Stephan Hacker & Joseph Raz eds., 1977).

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kind of ex post sharing, which we call *cooperative sharing*, is certainly known to contract law—it is displayed by joint venturers or other fiduciaries, for example, as in Cardozo’s famous remark that joint venturers owe one another “the punctilio of an honor.”¹⁰⁰ Moreover, there is a close connection between contract and cooperative sharing. In particular, at least among parties who begin their relations at arm’s length, cooperative sharing can be achieved *only* ex post, that is, within the solidaristic relation established by an exchange of (contractual) promises.

Cooperative sharing has an at best uncertain appeal for the efficiency-minded. To be sure, a legal regime that supports or even imposes cooperative sharing may serve efficiency in the narrow class of circumstances in which the parties cannot anticipate at the time of contracting what the optimal exchange will turn out to involve (and perhaps also cannot verify ex post whether the other party has satisfied whatever standards the contract attempts to set).¹⁰¹ But in the broader class of cases in which performance can be described in advance and is verifiable, cooperative sharing reduces the promisee’s expected return and increases transaction costs. Efficiency is not the only value, however, and at least some moralists about contract may be understood to propose another, broader, justification of cooperative sharing in contract, based on such sharing’s *intrinsic* moral value. In its most general form, this moralism about contract claims that the morality of promise requires cooperative sharing in *all* promise relations. All contracts contain promises; hence, the morality of promise requires the law to support, or at least not to undermine, cooperative sharing in contracts generally. On this view, the moral value of cooperative sharing outweighs the efficiency generated by the unilateralism that liability rule protection of the expectation makes possible.

A moralism that insists on cooperative sharing in contract rejects the expectation remedy because the remedy undermines cooperative sharing, as indeed such sharing is equally (if oppositely) un-

¹⁰⁰ *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

¹⁰¹ See *supra* text accompanying notes 33–34 (outlining our epistemic assumptions). One of us has also proposed a related argument for the case of relationship-specific investments made in particular circumstances. See Alan Schwartz & Robert Scott, *Precontractual Liability and Preliminary Agreements*, 120 Harv. L. Rev. 661, 665–67 (2007).

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dermined by the remedy that Brooks prefers. Both remedies quarantine contractual sharing within the ex ante state and allow one party or the other unilaterally to pursue her own interests ex post. Indeed, both remedies achieve their efficiencies in part by carrying the competitive relationship that characterizes pre-contractual bargaining *into the interstices of the contract relation*. We therefore conclude our moral analysis of the expectation remedy by asking how this feature of the expectation remedy stands with respect to the morality of promising. Our procedure is first to demonstrate that an ideal of cooperative sharing is the source of certain moralist attacks on the expectation remedy and then to ask whether this ideal is appealing, at least in the context of commercial contracts.

The most sustained elaboration of this moral criticism of the expectation remedy appears in the work of Seana Shiffrin, who, in a recent article, identified the expectation remedy and the practice of “efficient breach” as one of several places at which contract law unappealingly departs from the morality of promising¹⁰² and who has now elaborated the nature of this departure in greater detail.¹⁰³ Cooperative sharing does not figure expressly into Shiffrin’s argument, however, and so it takes some interpretive work to show that this ideal is the foundation of her objection to the expectation remedy.

Shiffrin makes two claims concerning the expectation remedy, which together provide a point of entry to her argument’s deeper structure. First, she claims that, under current law, when a promisor transfers rather than trades, the promisee must realize trade himself, at best with the transferred funds. For example, a buyer whose seller rejects trade must make a substitute purchase.¹⁰⁴ Second, Shiffrin observes that conventional contract doctrine imposes on the promisee a *legal obligation* to act on his promisor’s behalf, in the sense that the promisee must arrange a substitute at least cost to the promisor. In the language of the doctrine, the promisee must mitigate the promisor’s damages.¹⁰⁵ Shiffrin is hostile to both

¹⁰² See Shiffrin, *The Divergence of Contract and Promise*, supra note 5, at 729.

¹⁰³ Shiffrin, *Could Breach of Contract Be Immoral*, supra note 5, at 1552.

¹⁰⁴ See id. at 1564–65.

¹⁰⁵ Id. This requirement also may be expressed in causation terms. The promisor’s failure to trade creates an expectation loss for the promisee. Any damage increment above this loss that a cost-justified promisee action could have prevented is attribut-

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aspects of the doctrine. In her view, the disappointed promisee has been betrayed. Forcing him to reenter the market, and in a manner that weighs the promisor's interests as equal to his own, adds insult to injury.

Shiffrin's claim that the doctrine insults a disappointed promisee is important. To be sure, Shiffrin also objects to the doctrine because the duty it creates may be costly for the promisee to satisfy. For example, she worries about the serious inconvenience a homeowner incurs when a plumber refuses to repair.¹⁰⁶ Her distaste for mitigation cannot rest on the existence of such costs, however. Mitigation requirements are structured so that a buyer who mitigates is supposed to be at least as well off as performance would have left him: any costs that mitigation causes are compensable as incidental damages. In the real world, of course, some mitigation costs—emotional upset, hours spent finding another contract partner—may go uncompensated. But that is a defect in the law rather than its purpose, and Shiffrin's objection is to the law's ideals. Hence, she claims, the objection would hold even in a fantasy world in which to mitigate would cost promisees nothing.¹⁰⁷

Insult thus is the gravamen of her critique. It is the case, in the fantasy world as well as ours, that a promisor who rejects trade has unilaterally allocated to the promisee the task of securing a substitute performance. Shiffrin adds, though admitting that this way of speaking exaggerates the point, that the promisor has made the promisee her "involuntary employee." As Shiffrin says, "[s]he has usurped [his] ability to make independent, voluntary decisions about the use and form of [his] time, attention, and labor." And

able to the promisee. As an example of the law's causation language, a buyer may recover "any loss . . . which could not reasonably be prevented by cover or otherwise." U.C.C. § 2-715(2)(a) (2011). A promisee's limited right to recover can be justified on either causation or mitigation grounds because both grounds rest on the same premise, that the promisor is obligated to pay the expectation but is not obligated to trade. The promisee thus causes any loss above the expectation and must achieve trade on his own.

¹⁰⁶ Shiffrin, *Could Breach of Contract Be Immoral*, supra note 5, at 1564–65.

¹⁰⁷ Id. We do not deny that this is a fantasy or that the expectation remedy and mitigation requirement, as administered, sometimes are undercompensatory. We devote these pages to defending what the critics (Shiffrin included) attack, namely the idealized, fully compensatory expectation remedy.

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this usurpation, when done to a free and rational person, is an insult.¹⁰⁸

It is incorrect to claim that promisees are insulted, however. Shiffrin's argument presupposes what we deny: that the typical contract requires the promisor only to trade, so that her failure to trade is a breach whose consequences the promisee must mitigate. Rather, we show that the promisee's payoff, in the critics' ideal world, is invariant to whether the contract requires trade or whether the contract permits the promisor to choose whether to trade or to transfer. In more realistic scenarios, the promisee's return is higher under the latter, liability rule contract.¹⁰⁹

An additional reason for this preference, not set out above, exists when the promisee can procure a substitute more cheaply than the promisor. In these common cases, the price is lower when the promisor is permitted to reject trade because the price reflects the promisor's costs. A legal regime in which a promisee must mitigate therefore does not impose any involuntary obligation on the promisee; rather, it makes him the beneficiary of an efficient contract whose terms he chose. (He is the beneficiary because, recall, the gains associated with mitigation are shared through the contract price.) A buyer who purchases under the standard contract has therefore not been rendered the promisor's employee but rather, as it were, mitigates on his own account. The mitigation requirement thus not only advances the promisee's interests; it is an expression of his freedom.

¹⁰⁸ Id. at 1564; see also Shiffrin, *The Divergence of Contract and Promise*, supra note 5, at 724–26. Shiffrin uses the example of a homeowner and a plumber to make these points. This example is significant. A natural person who is a promisor may insult a natural person who is a promisee, but it may be a category mistake to claim that Corporation A “insults” Corporation B by refusing to trade. Shiffrin criticizes the mitigation requirement as it applies everywhere, but it takes, we think, a theory of “corporate insult” to show that the criticism applies in commercial contexts. No such theory exists, at least at present (although one of us thinks it might be developed). The text above, however, meets her argument on the general terms in which it is expressed.

¹⁰⁹ Shiffrin also criticizes the mitigation requirement because promisees, in her view, desire for themselves the goods and services that constitute trade rather than (as the mitigation requirement supposes) view trade as a way station on the road to further economic advantage. See Shiffrin, *Could Breach of Contract Be Immoral*, supra note 5, at 1565. This claim, too, seems out of place in the typical commercial exchange. A business buyer does not want goods or services *simpliciter*; he wants the gain that trade in goods or services yield. It follows that he prefers the contract that maximizes his expected gain to the lower value contract that requires trade always.

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But Shiffrin (unlike Friedmann and Brooks) identifies another ground for insisting that promisors are obligated specifically to trade, a ground that sounds in the character of the contract relation. This comes out later in her argument, when she remarks on an apparent asymmetry between the parties' positions before and after they contract. A promisee cannot force his promisor to enter into a contract by offering to pay the price of the contract's action terms (a buyer may not force someone to sell by offering to pay the good's market price). Once a contract is made, however, the promisor can force her promisee to replace her trade with someone else's (at least where cover is efficient, a seller may force her buyer to cover).¹¹⁰ It is at least "peculiar,"¹¹¹ Shiffrin says, that a promisor enjoys greater protection against involuntary interference from her promisee without the contract relation than her promisee enjoys against involuntary interference from her within it. "[T]here is no clear reason why after the relationship is formed, [the] nonconsensual behavior [involved in a promisor's unilateral decision to transfer rather than to trade] should be more morally anodyne than it would have been ex ante."¹¹² Indeed, Shiffrin suggests, such behavior is simply wrong.

There is a "clear reason," however, which is that the promisor's actions are consensual. Under what we have called the liability rule contract, the promisee agrees, in return for a price reduction, to permit the promisor later to choose between trade and transfer. The promisor's "unilateral decision" thus is no more unilateral than is the decision of any agent whose principle instructs her to choose between two permitted acts. We shall give this explanation of the parties' preferences a moral interpretation in a moment.¹¹³

¹¹⁰ This is not quite literally so: a seller cannot *require* her buyer to cover but only to choose between covering and not getting the good at all.

¹¹¹ Shiffrin, *Could Breach of Contract Be Immoral*, supra note 5, at 1566.

¹¹² *Id.*

¹¹³ Shiffrin raises a final economic argument against understanding contracts, as we do, to involve promises to trade or to transfer. She observes that promisees typically enter into contracts because they are interested in receiving the specific goods or services that the contracts' promises specify rather than the generic value of these goods or services, as reflected in the contracts' transfer terms. *Id.* at 1565. She then invites one to "[c]onsider the absurd result in such cases if the payment of expectation damages were the universalized, reflexive response to agreements. No promisee would ever get what she sought. As a further consequence, if this were the universalized response, then agreements would never be made." *Id.* This argument apparently as-

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But first we observe that Shiffrin's concern is justifiable on a different view of the contract relation. According to this view, entering into a contract changes the relationship between contracting parties, so that even where they have *approached* each other at arm's length, the contract makes their relation *within it* closer than arm's length. The parties' duties under a contract thus cannot be measured by the contract alone.¹¹⁴ Instead, parties have an open-ended duty to cooperate. This duty requires each party to respect the interests and motives that led the other to enter into the contract and to adjust to new facts and circumstances in a way that is other-regarding in respect of these motives and interests. Shiffrin reasons from the existence of this duty to the conclusion that while a promisor may refuse to make a contract, though the potential promisee offers a fair price, the promisor cannot both contract and keep the promisee at arm's length regarding performance. To be precise, when contract law authorizes the promisor to choose ex post between transfer and trade, depending on which maximizes her utility, the law thus undermines the cooperative sharing that constitutes the moral essence of the promissory relation and hence also of contract. Shiffrin's view that a promisor who transfers rather than trades drafts her promisee into her service, in the same way that a promisee would do if he could force the promisor to contract by offering the market price, thus is explicable only on the assumption that contracts typically replace arm's length sharing ex ante with cooperative sharing ex post.

sumes that a seller who has the right either to trade or to transfer will always choose to transfer. Section II.A above shows, in contrast, that the seller chooses to transfer only when trade would produce a larger loss. Since giving the seller the ability to minimize ex post losses maximizes the buyer's expected return, there is *more trade* under the expectation interest remedy than there would be under Shiffrin's proposed remedial scheme.

¹¹⁴ Here it is worth noting a contrast between such an open-ended duty to cooperate and the mandatory duty of good faith in performance that contract law imposes. The content of the duty of good faith is limited by the content of the parties' promises: good faith forbids each party from exploiting vulnerabilities that arise over the course of a contract relationship in ways that prevent the other from realizing the benefits that the contract confers. Good faith is thus a duty that exists only at arm's length—a duty not to exploit subsequent events in ways that undermine the division of surplus that the initial arm's length agreement fixed. Unlike cooperative sharing, good faith does not involve any open-ended obligation to attend to the motives and interests of the other party in ways that extend beyond the division of surplus agreed to in arm's length sharing ex ante. See generally U.C.C. § 1-304 (2011).

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This analysis explains Shiffrin's view but does not justify it. Commercial parties, we show, *prefer* to let the promisor choose between trade and transfer. Hence, Shiffrin's view commits her to the claim that contract law should override the parties' preferences in order to force them to be good. To understand why Shiffrin is committed to paternalism, consider the cases in which the law applies a cooperative model of ex post sharing within promissory or contractual relations: marriage and, more generally, joint ventures.¹¹⁵ Sharing in these relationships cannot be cabined by the terms of the agreements that establish them: a fact that is self-consciously announced by the language of the marriage vow—"for better or for worse"—and by the duty of fiduciary fidelity that joint venturers owe to each other. Sharing is not cabined contractually because these relationships involve the adoption of a shared project: a family, in the case of marriage; and a business enterprise, in the case of a joint venture. The parties to such contracts agree to pursue the projects (at least in some measure) apart from the contributions that the projects make to their individual interests: as measured by these interests, the parties, sometimes literally, agree to pursue their projects for better or for worse. And in these cases something like Shiffrin's analysis of breach applies. A promisor who transferred rather than traded would betray the joint venture's shared project in favor of the antecedent purely personal interests that the project was intended to replace, and vindicating her promisee's expectation interest would similarly measure the value that

¹¹⁵ Thus courts commonly observe that "[j]oint venturers, like partners in a partnership, owe a fiduciary duty to one another." *Miami Subs. Corp. v. Murray Family Trust*, 703 A.2d 1366, 1373–74 (N.H. 1997); see also, e.g., *Elec. Assocs., Inc. v. Automatic Equip. Dev. Corp.*, 440 A.2d 249, 251 (Conn. 1981) ("As a matter of law, parties to joint ventures undertake fiduciary duties to each other concerning matters within the scope of the joint venture." (citing *Sime v. Malouf*, 212 P.2d 946, 954–55 (Cal. 1950)); *Lucas v. Abbott*, 601 P.2d 1376, 1379 (Colo. 1979)). The marriage relation establishes analogous duties among the partners. Thus:

Courts simply should not countenance either party to such a unique human relationship [i.e., marriage], dealing with each other at arm's length . . . We have recognized, furthermore, in the context of an action based upon fraud, that the special relationship between fiduciary and beneficiary compels full disclosure by the fiduciary. Although marital parties are not necessarily in the relationship of fiduciary to beneficiary, we believe that no less disclosure is required of such parties when they come to a court seeking to terminate their marriage. *Billington v. Billington*, 595 A.2d 1377, 1381 (Conn. 1991).

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he placed on performance in a metric that the initial contract agreed to abandon. But note that the betrayal is of the relation that the parties *ex ante* agreed to establish. The law requires cooperative behavior *ex post* to implement the parties' *ex ante* preference for a sharing regime. And most parties, in most circumstances, do not prefer this regime.

Thus, even purely personal promises seem intuitively often to involve only *ex ante* sharing cabined by the terms of an agreement rather than cooperative sharing *ex post*. Suppose, for example, that a sports-lover promises to treat her opera-loving friend to a performance of *Pelléas et Mélisande* and that when she goes to buy the tickets she learns that only unexpectedly expensive seats remain available and therefore decides not to give the treat. What ought she now to do? To be sure, she cannot vindicate her promise by giving her friend a cash payment equal to the value that he ascribes to seeing the opera. But the reason why the ordinary morality of promising balks at such cash payments is not necessarily that it rejects the idea of equivalent performance, *tout court*, but only that introducing money payments into personal relations has commodifying and alienating effects and hence is generally taboo.¹¹⁶ Moreover, suppose that the promisor discovers that *Rodrigue et Chimène* is playing across town, that ordinarily-priced seats remain available there, and that her friend loves both operas equally. If she unilaterally substitutes the second opera for the first, has she committed a wrong, or indeed even broken her promise?

We think that, save in unusual circumstances, she has not. An arrangement of this sort is best understood as a promise to give her friend a treat of a certain (rough) cost and value. As it turned out, delivery of the treat that the promise expressly named—the analog of trade—was unexpectedly, and inefficiently, expensive, and so the promisor substituted an alternative performance—the analog of transfer—that made her friend whole and cost her less. That

¹¹⁶ The same effect may readily be seen in a tort-like context, for example, when a dinner guest breaks one of his host's wine glasses. Although the guest clearly has a duty of redress, paying the host the cash value of the glass will not satisfy it (and may even make matters worse). Moreover, although the guest might satisfy his duty by giving the host a replacement glass, he might also (and indeed better) make redress by providing some alternative (and roughly equivalent) gift, for example, a bunch of flowers or a box of chocolates.

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there is no breach may be seen intuitively by observing that, although the promisor might in this case owe her friend an *explanation* for the change, she would not, once the explanation had been given, owe any further *apology*. Indeed, if the friend sought to extract an apology then he, and not she, would conventionally be thought to be violating the norms implicit in their relationship. Things might be different if the friends were both opera-buffs whose promises established the shared project of finally seeing *Pelléas et Mélisande*, as the personal equivalent of a joint venture. In this case, the friends have made a commitment to seeing that particular opera as a non-instrumentally valued, shared goal, and so the first friend might be unable to acquit herself of her part in the plan by substituting another opera of equivalent instrumental value. But most personal promises, we think, are more like the original case than the modification. They are viewed by parties to them as instruments useful in pursuing antecedent and independent purposes, and they may therefore be honored by means alternative to those that they expressly name.

In any event, this instrumental account better captures the character of commercial promises—and hence of contracts—than the non-instrumental alternative associated with the joint venture model. The parties to contracts typically view each other and the trades that their contracts' action-terms describe as instrumental (and hence in principle interchangeable) means in the pursuit of commercial ends that pre-date, and are not altered by, the commitments that the contracts establish. This is as it should be.¹¹⁷ Contract law's moral (and not just economic) purpose is to enable coordination on neutral terms in an open and pluralist economic and political order. In this order, contracts may arise between parties on either side of every economic and political dispute. And con-

¹¹⁷ One of us has previously argued that contracts establish a certain form of joint activity among the parties to them, that this activity is characterized by sharing the end of achieving the contractual performance, and that this sharing underwrites the contract relations' moral worth. See Daniel Markovits, *Contract and Collaboration*, 113 *Yale L.J.* 1417, 1456–58 (2004). But the kind of sharing described there remains quite different from the ex post cooperation associated with a view like Shiffrin's. It is confined *within* the contract and has its content fixed by the terms of the contract, and it is therefore much thinner than cooperative sharing (a point emphasized by calling such sharing collaboration and expressly rejecting the idea that it involves cooperation, see *id.* at 1457).

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tract law can be open in this way only if parties can contract without ceding control over their larger purposes—that is, without committing themselves to cooperative sharing *ex post* in service of non-instrumental values. Turning to contract law's connection to liberty rather than to neutrality, a legal order that insists on cooperative sharing *ex post* is inconsistent with freedom of contract. This order would convert the contract relation into a kind of organic community, almost a status order, that parties may avoid altogether but cannot freely contour and constrain.

The tension between the modes of sharing associated with ordinary contract and cooperative sharing is greater still. To see why, observe that the mode of sharing involved in promise and, *a fortiori*, contract is incompatible with there being a *total identification* between the parties—this is just a way of characterizing the familiar thought that to make a promise to oneself is impossible. Moreover (although this will likely be a more controversial claim), promissory and contractual sharing are also difficult to establish among parties who, although not totally self-identical, nevertheless possess *very close* antecedent connections. In the personal realm, for example, it is difficult to make effective promises within fully companionate marriages, because both partners' commitments to maximizing their joint outcome (viewed as a non-instrumental value) mean that any promissory rights that might arise between them will dissolve when this is no longer, from the point of view of the couple, best overall.¹¹⁸ And even in the commercial realm, there exist limits on freedom of contract within fiduciary relationships,¹¹⁹ because the self-interest that lies at the core of contractual sharing is incompatible with the cooperative attitudes required by the fiduciary form. Cooperative sharing, on Shiffrin's model, therefore

¹¹⁸ See Daniel Markovits, Promise as an Arm's Length Relation, *in* Promises and Agreements: Philosophical Essays 295, 309–13 (Hanoch Sheinman ed., 2011).

¹¹⁹ For example, a lawyer may not represent a client if the representation involves “the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal,” Model Rules of Prof'l Conduct R. 1.7(b)(3) (2007), or more generally, if she cannot “provide competent and diligent representation to each affected client.” *Id.* at R. 1.7(b)(1); see also Restatement (Third) of the Law Governing Lawyers § 122(2)(a) (2000). In each case, it does not matter if the client knowingly agrees to the representation, nevertheless. Freedom of contract does not penetrate the fiduciary lawyer-client relation, and the conflicts are, in the language of the law of lawyering, non-consentable.

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does not just present an alternative to the thinner forms of solidarity associated with contractual sharing as we understand it; rather, where it arises or is imposed, cooperative sharing makes contractual solidarity impossible. Shiffrin's model is therefore, strictly speaking, *incompatible* with the forms of sharing associated with contract.

The ex ante sharing associated with the expectation remedy and the view that contracts involve promises to trade or to transfer therefore better match not just the economic but also the moral purposes of contract than does Shiffrin's alternative. For these reasons, we reject cooperative sharing ex post as the right model of the contract relation. Instead, the substantive values associated with promissory morality, when applied to the special case of contractual promises, favor arm's length, ex ante sharing. Moreover, our economic model reveals that parties who engage in arm's length sharing produce agreements that do not fetishize trade over transfer but rather permit promisors to honor their promises by performing the promises' transfer terms. The morality of promising thus aligns with the economics of contract. These reflections suggest that in addition to being formally consistent with taking a moralistic view of contract law, protecting the expectation with a liability rule (properly understood as an interpretive presumption) is also consistent with promissory morality's substantive ideals, at least when these are applied to the ordinary circumstances of commercial contracting.

CONCLUSION

The expectation interest remedy is traditionally justified because it produces efficient breach: the promisor breaches only when her gain from breach would exceed the gain that the promisee would have made from trade because the remedy requires the promisor to pay the promisee's trading gain. This justification of the remedy is weak. It holds that the remedy yields ex post efficiency, but ex post efficiency is realizable under any remedy because parties can renegotiate to the ex post efficient state regardless of the initial legal starting point. When every remedy yields the same ex post outcome, parties who decide on monetary grounds, such as firms, seemingly have no reason to prefer any particular remedy at the contracting stage.

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Critics of the expectation interest remedy propose replacing it with property right remedies, such as specific performance. On the critics' view, a contractual promise creates in the promisee a right to the promisor's performance. Rights are best protected with property rules. In addition, a property rule regime produces a fairer distribution of the savings from avoiding inefficient performances than the expectation regime. The critics' view, however, is subject to the same irrelevance critique. All remedies put the promisee in the same (monetary) place; hence, every remedy necessarily protects the promisee's rights and is equally attractive distributionally.

We break this theoretical tie by relaxing two assumptions that are made in the expectation debate: contracting and renegotiation are costless and promisors always can pay. When these assumptions are discarded but the assumption that courts are sufficiently informed to protect the expectation is retained, promisees, we argue, prefer contracts that confer on the promisor discretion either to satisfy the contract's action terms—to supply the specified goods or services—or to pay the gain that performance of those terms would have yielded. What we call “the dual performance hypothesis” supposes typical promisees to have this preference; hence, our argument validates the hypothesis if it persuades.

We defend the hypothesis on five related grounds: (i) Under the conditions the critics assume, a promisee's expected gross payoff under a contract does not vary with the remedy he has. A property rule contract gives the promisee the power to capture a share of the gain that rejecting trade creates through a renegotiation; markets give the promisee to a liability rule contract the power to capture the same share of the gain through the vehicle of a lower price. (ii) A promisee's expected net payoff often is higher under the liability rule contract because it is less costly to write than a property rule contract and, unlike the property rule contract, can yield ex post efficiency without renegotiation. (iii) Were both contract types enforceable, the liability rule contract would be a good default when courts are sufficiently informed to protect the expectation; parties would accept the default because contracts that protect the expectation with a liability rule commonly are maximizing relative to contracts that create property rights. (iv) A promisee's consent to a liability rule default is actual rather than hypothetical.

2011]

Myth of Efficient Breach

2007

The price of a contract is a joint function of the cost of the action terms and the size of the transfer term. Sophisticated parties pay attention to what deals buy them and thus pay attention to both components of the price. (v) “Efficient” breach is a myth because no true breach—a promisor’s failure either to trade or to pay—can be efficient.

These grounds support our claim that the expectation remedy is analytically consistent with the immanent normative structure of contract. The expectation remedy is also formally consistent with taking a moralistic approach to contract law, according to which true breaches of contract are wrongs that can qualify for punitive damages. Additionally, we argue that the *ex ante* sharing associated with the expectation remedy best captures the substantive ideals behind promissory morality, at least as these ideals are worked out for the case of promises among strangers in open, pluralist economic and political orders. Together, these arguments renew the overall case for making expectation damages the standard remedy for breach of contract.¹²⁰

Our broader argument is best understood as pursuing a representation result—that is, it is an effort to lay bare the formal structure of the contract relation.¹²¹ We have shown that a certain set of economic, philosophical, and legal ideas can represent a particular legal practice. More specifically, we demonstrate that the substitutionary account of the expectation remedy (which is implicit in both the efficient breach hypothesis and the writings of those who criticize efficient breach) is merely epiphenomenal and, moreover, misleading. We explain the expectation remedy more accurately without including any substitutionary remedy in the explanation, instead treating every contract remedy as formally an instance of specific performance and allowing the content of the obligation that is being specifically enforced to vary, according to the dual performance hypothesis.

¹²⁰ We remind readers that this result holds only when the buyer’s value is verifiable or the buyer can be made whole by cover and market damages. When these conditions are absent, parties have an incentive to contract for liquidated damages or property rule protection. Courts should enforce both contract types. See, e.g., Schwartz, *supra* note 58.

¹²¹ We thank John Mikhail and Henry Smith for pressing us helpfully on this point.

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This representation result matters for legal practice—for the development of doctrine and the outcomes in concrete cases. The criticisms of the expectation remedy that we seek to debunk may be understood, at a general and abstract level, as asserting that the substitutionary account of the expectation remedy implicit in the theory of efficient breach is inconsistent with the formal structures of contract and promise that law and morality establish. Insofar as courts and other lawmakers accept these criticisms, they will be tempted (as in the Restatement (Third) of Restitution and in *EarthInfo, Inc. v. Hydrosphere Resource Consultants, Inc.*¹²²) to award disappointed promisees supracompensatory remedies on the model of disgorgement. Our argument, however, demonstrates that to do this is wrong: the actual formal structure of contract and promise—which makes specific performance (formally understood) the only remedy for breach—is sufficiently capacious to support the efficient outcomes that the theory of efficient breach recommends.¹²³ We therefore affirm the still-conventional account of the positive law against its revisionist critics.

¹²² 900 P.2d 113, 120 (Colo. 1995).

¹²³ See, e.g., Restatement (Second) of the Law of Contracts § 344 (1981).