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A Nihilistic View of the Efficient Breach

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A NIHILISTIC VIEW OF THE EFFICIENT BREACH

Jeffrey L. Harrison*

2013 MICH. ST. L. REV. 167

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“... same as it ever was ...”

Brian Eno, David Byrne, Christopher Frantz, Tina Weymouth

[“We’ve] got nothing to say and [we’re] saying it [again].”

John Cage

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INTRODUCTION

For forty years scholars have debated the concept of the efficient breach of contract.¹ One would think that everything that could be said has been said except to note the futility of the discussion. Yet, recently, the debate has flared up once again.² The primary focus of the exchange is whether the expectancy measure of contract damages encourages the efficient breach and the reallocation of resources to those who value them the most.³ It is the type of issue that legal scholars delight in—all views can be supported or refuted and the likelihood of an empirical answer is remote.⁴ This

1. The efficient breach will be discussed in greater depth later, but for the uninitiated, the theory is that contract damages set at the expectancy level encourage efficient breach of contract. See, e.g., Barry E. Adler, *Efficient Breach Theory Through the Looking Glass*, 83 N.Y.U. L. REV. 1679, 1680-81 (2008); David W. Barnes, *The Anatomy of Contract Damages and Efficient Breach Theory*, 6 S. CAL. INTERDISC. L.J. 397, 398-400 (1998); Shawn J. Bayern, *False Efficiency and Missed Opportunities in Law and Economics*, 86 TUL. L. REV. 135, 160-61 (2011); Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 YALE L.J. 568, 570, 572-73 (2006); William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 DUKE L.J. 629, 653-54 (1999); Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 93 CALIF. L. REV. 975, 977-78 (2005) [hereinafter Eisenberg, *Actual and Virtual Specific Performance*]; Melvin A. Eisenberg, *The Disgorgement Interest in Contract Law*, 105 MICH. L. REV. 559, 570 (2006); Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1444 (1980); Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 1-2 (1989); Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. COLO. L. REV. 683, 686-87 (1986); Daniel Markovits & Alan Schwartz, *The Myth of Efficient Breach: New Defenses of the Expectation Interest*, 97 VA. L. REV. 1939, 1944-45 (2011); Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085, 1091 (2000); Seana Shiffrin, *Could Breach of Contract Be Immoral?*, 107 MICH. L. REV. 1551, 1552 (2009) [hereinafter Shiffrin, *Breach of Contract*]; Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 730-33 (2007) [hereinafter Shiffrin, *Divergence of Contract*]; Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 344-45 (1984); Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365, 1394 (1982).

2. Remarkably, Daniel Markovits and Alan Schwartz have claimed to have found new ways to defend the efficient breach. See generally Markovits & Schwartz, *supra* note 1. For a discussion, see *infra* Part IV. Responding directly to Professor Markovits and Schwartz are Gregory Klass, *To Perform or Pay Damages*, 98 VA. L. REV. 143 (2012), and Seana Valentine Shiffrin, *Must I Mean What You Think I Should Have Said?*, 98 VA. L. REV. 159 (2012). Markovits and Schwartz's use of myth should not be confused with the nihilistic view discussed. Their use of the term "myth" stems from their argument that paying damages for non-performance is not a breach because both parties understood that payment of damages was an alternative method of performance. Markovits & Schwartz, *supra* note 1, at 1948-49.

3. See sources cited *supra* note 2.

4. It would be difficult to claim that courts have found the scholarship very useful. Since 1970 the term "efficient breach" can be found in the literature over 1,500 times, but is

Article argues that there can be no answer, not even a reliable default position.

Although expressed in terms of expectancy, in reality the discussion began when expectancy was effectively “rebranded” in the 1970s as the remedy that leads to the “efficient” breach.⁵ Until then, expectancy had been around for more than a century without causing much of a stir.⁶ As soon as it was viewed as arguably efficient, the writing began unabated. Robert Birmingham appears to have been the first to note that expectancy could also be squared with efficiency.⁷ Richard Posner along with Charles Goetz and Robert Scott echoed the same theme in the same period.⁸ In fact, two ideas blossomed from this scholarship. One was that a breach of contract could be “efficient.”⁹ The other was that expectancy encouraged or allowed the efficient breach.¹⁰

The rebranding of the 1970s did not please everyone and, by the early 1980s, the battle was joined.¹¹ It is an odd debate for a number of reasons. Not only had expectancy been around for a very long time before becoming the focus of thousands of pages of writing, the rebranding was only that—nothing substantive changed. In other words, expectancy was and still is just that. Like so much of law and economics, the upshot of many arguments was to provide a new basis for continuing the status quo. Thus, the thousands of pages can only be explained by the discomfort with what expectancy could be viewed as signifying. This leads to the question of what the

mentioned by all federal and state courts only 140 times. This data is based on a Westlaw search under “TP-ALL” and “ALLCASES,” respectively.

5. This possibility seems to have been first noted by Robert Birmingham. *See generally* Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273 (1970).

6. *See generally* A.W.B. SIMPSON, *LEGAL THEORY AND LEGAL HISTORY: ESSAYS ON THE COMMON LAW* 217-19 (1987).

7. *See generally* Birmingham, *supra* note 5.

8. Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 556-58, 578-93 (1977). Richard Posner’s treatment begins in the first edition of *Economic Analysis of Law*. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 55-59 (1972). In this edition, Posner notes that a penalty clause may prevent the efficient breach. *Id.* at 59-60. The analysis is also found in the 7th edition. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 118-26 (7th ed. 2007) [hereinafter POSNER, 7th edition].

9. *See* Birmingham, *supra* note 5, at 281-82.

10. *See* E. ALLAN FARNSWORTH, *CONTRACTS* 736-37 (4th ed. 2004). This distinction is important because the theory that efficient breach exists is a different matter than the practical one of which remedy achieves that end. *See id.* at 737.

11. Although a bit delayed, three articles in particular seemed to start the debate. *See generally* Peter Linzer, *On the Amoralism of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111 (1981); Farber, *supra* note 1; Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982).

brouhaha is about. What is the attraction? One explanation is that the concept is easy to explain and to understand and provides a portal into a host of questions that are asked more generally about the application of economics to law. It is not unique in this respect. Most of law and economics is relatively easy to grasp and raises more general issues.

Commentators fall into three categories. In one category are those who seem comfortable with the idea of an efficient breach but focus on which remedy is consistent with that outcome.¹² Within this category the tension is usually between damages and specific performance or one of its surrogates.¹³ There have been defenses¹⁴ and “new defenses”¹⁵ of expectancy and even the possible conversion of one scholar, previously an advocate of specific performance, to a believer in expectancy.¹⁶ Another category is composed of those who believe that contract law has or should have a higher, or at least different, goal. They want to attribute a deontological value to a paid-for promise typically made at arm’s length.¹⁷ Typically, they find that

12. See generally Ulen, *supra* note 1; Markovits & Schwartz, *supra* note 1. Perhaps the most thorough explanation of why expectancy fails to result in efficient breaches is found in Farber, *supra* note 1, at 1443-45.

13. The term “surrogate” refers to the fact that liquidated damages and punitive damages for breach of contract often have the same effect as specific performance. See *infra* Part III. For a summary of the attacks on damages and defenses, see Eisenberg, *Actual and Virtual Specific Performance*, *supra* note 1, at 981-89. Perhaps the earliest proponent of specific performance was Anthony Kronman. See generally Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978). While this quibbling has gone on (and it is hard to see it as much more than that since it is of far greater interest to scholars than to anyone else), new information from behavioral economics and happiness studies complicate the issue in a manner that seems to make the prior arguments obsolete. See *infra* Section II.C.

14. See *supra* text accompanying notes 7-8.

15. See Markovits & Schwartz, *supra* note 1, at 1939, 1942-43, 1961-2005.

16. Compare Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979), with Markovits & Schwartz, *supra* note 1, at 1940, 1942.

17. Perhaps the best-known effort to find a moral dimension to be promising is CHARLES FRIED, *CONTRACT AS PROMISE* (1981). See generally Shiffrin, *Divergence of Contract*, *supra* note 1; Shiffrin, *Breach of Contract*, *supra* note 1. Although not pursued here, the moral claim seems weak. In general, a moral claim would appear to arise from something other than a bargained or “paid for” exchange. In short, if a promise is conditional upon receiving a promise in return, it is hard to elevate it to moral status. Nevertheless, recent research suggests, or seems to suggest, that a moral component is attributed to a breach of contract. See Tess Wilkinson-Ryan & Jonathan Baron, *Moral Judgment and Moral Heuristics in Breach of Contract*, 6 J. EMPIRICAL LEGAL STUD. 405, 405-06 (2009); Tess Wilkinson-Ryan & David A. Hoffman, *Breach Is for Suckers*, 63 VAND. L. REV. 1003, 1004-06 (2010). Still, there is a difference between whether something is morally wrong and whether people think it is or say it is. For example, many people believe same-sex marriage is morally wrong. Moreover, the level of the moral response seems to depend on the type of impact. Wilkinson-Ryan & Hoffman, *supra*, at 1014-16. This suggests that this type of moral indignation is simply one that is not adequately accounted for in damage calculations. Randy Barnett argues that the moral element is consent. See generally Randy E. Barnett, . . . And

there is a moral component of promising that a focus on expectancy and efficiency neglects or even discourages.¹⁸ Finally, very recently, the implications of the teachings of behavioral economics and happiness studies have been applied to the issue.¹⁹ The efficient breach, at the very least, seems to require rationality, a concept behaviorists have shown to be rather slippery.²⁰ Recent studies of happiness have revealed how little we actually understand about what makes people feel better off.²¹ This means the concept of efficiency cannot be pinned down with certainty. Even more troubling is the question of how to achieve it.

This Article explains why the illusion of efficiency can be traced to the limited scope of prior analyses. For example, there has not been sufficient focus on the problems of false positives and negatives created by expectancy and specific performance.²² A false positive is an incorrect belief that a breach is efficient; a false negative is an incorrect belief that a breach would be inefficient. This problem and the ultimate indeterminacy of the efficient breach are linked to two additional failures. First, damages for breach of contract are often seen as existing for the purpose of compensating the non-breaching party.²³ In fact, from an economic perspective, the question is whether the breaching party internalizes the cost of the breach. Perhaps more pressing, the typical analysis does not examine the impact of the payment of damages on firms downstream from the breaching party.²⁴ In other words, a breach does not affect only those who are parties to the contract. Yet most of the impact of the efficient breach is assessed by a narrow examination of the effects on the parties to the contract. Conventional scholarship about the efficient breach fails to extend the analysis far enough to fully grasp the complexity and likely futility of defining a remedy that is actually consistent with efficiency.

Writings about efficient breach bring to mind a recent article in which Monroe Freeman criticizes “philosophizing about legal ethics.”²⁵ He com-

Contractual Consent, 3 S. CAL. INTERDISC. L.J. 421 (1993). See also generally Richard A. Posner, *Let Us Never Blame a Contract Breaker*, 107 MICH. L. REV. 1349 (2009).

18. See sources cited *supra* note 17. For the most part, this Article steers clear of arguments about the morality of keeping and breaking promises; on the other hand, it does address some recent arguments that efficient remedies are morally supportable. See *infra* text accompanying notes 233-36.

19. See *infra* Section II.B-C.

20. See *infra* notes 76-81 and accompanying text.

21. See *infra* text accompanying notes 89-95.

22. See discussion *infra* Sections II.F, III.D.

23. FARNSWORTH, *supra* note 10, at 757.

24. Downstream refers to the impact on firms when they resell a finished good or purchase an input that is part of the manufacturing process of a good that will be sold to a final user or another manufacturer.

25. See generally Monroe H. Freedman, *A Critique of Philosophizing About Lawyers' Ethics*, 25 GEO. J. LEGAL ETHICS 91 (2012).

pares philosophizing about legal ethics to scholars in engineering arguing about the superiority of skyhooks over ordinary cranes or the impact of skyhook cables on air traffic.²⁶ In short, philosophizing about legal ethics is empty, self-indulgent, and meaningful to only a few. His comparison is equally applicable to discussions of efficient breach. Quite recently, two Yale scholars may have achieved the dubious pinnacle of skyhook philosophizing in the context of the efficient breach.²⁷ Among other things, they present an argument favoring expectancy over specific performance without linking either to the idea of efficiency. If neither is consistent with efficiency—and they do not demonstrate that they are—then the point is lost.

Part I presents two examples of the efficient breach and explains why expectancy is regarded as efficient. One important aspect of the discussion is the focus on ensuring that a breaching party internalizes—treats as a cost—the harm to the non-breaching party.²⁸ These examples will be referred back to throughout the Article. Part II discusses the competing definitions of efficiency that complicate the question. It also addresses some of the new teachings from behavioral economics and happiness studies that increase the elusiveness of the already elusive efficient breach. An economic construct—the *contract curve*—is employed to demonstrate the failings of expectancy. Part III examines specific performance. Specific performance, probably the most favored remedy among those writing in the last forty years, is actually deeply flawed from the perspective of economic efficiency. Part IV considers some more recent defenses of expectancy and shows that they are not new and rely on assumptions that should be discarded, if they have not been already. In particular, the new defense seems to be an attempt to revive the notion of *ex ante* compensation,²⁹ a theory that has little merit in theory or practice.³⁰ In conclusion, this Article notes that no remedy can be favored over any other as an incentive for efficient breach or non-performance.³¹ Indeed, perhaps the underlying message of this Article

26. See *id.* at 104; see also Daniel A. Farber, *The Case Against Brilliance*, 70 MINN. L. REV. 917, 920 (1986) (“Examples of truly brilliant economic theories abound. Unfortunately, however, most are simply too brilliant to be true.”).

27. See Markovits & Schwartz, *supra* note 1.

28. See *infra* Section I.B. The implications of other remedies are discussed in Part III.

29. See *infra* Part IV.

30. Jules Coleman, *Efficiency, Utility and Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980); Ronald Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191 (1980). In addition, *ex ante* compensation was advanced by Richard Craswell in 1988. Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 632-33 (1988).

31. See *infra* Part IV. The term *non-performance* is used here instead of *breach* because many potential breaches are avoided if the parties agree to non-performance—usually at a price paid by the potentially breaching party. See *infra* text accompanying notes 135-43.

is that rather than clarifying the law, scholarly efforts have made it cloudier. In fact, to the extent certainty itself is of value, the starts and stops of legal scholarship and its varying recommendations have not been particularly useful. Legal scholarship itself may, at best, have no effect and may add to the uncertainty that makes efficient non-performance less likely.³²

I. EXPECTANCY AND THE EFFICIENT BREACH: PASSING A ROPE THROUGH
THE EYE OF THE NEEDLE

A. The Standard Models³³

1. *Model 1*

The simple efficient breach typically follows a scenario like this. Todd contracts to buy Jane's 2012 Honda Accord for \$6,000, which happens to have an average market value of \$6,500.³⁴ No money is paid down and delivery is to be in two weeks. A week after the contract is made Felix offers Jane \$8,000 for the car.³⁵ He does this because red Honda Accords are hard to find, and he is completing his collection of Hondas. Jane, realizing the damages for breaching would be \$500, breaches the contract with Todd, pays Todd the \$500 damages to which he would be entitled under an expectancy theory, and keeps a \$1,500 "profit."³⁶

Why is this efficient? According to the theory, both Jane and Felix are better off because of the breach.³⁷ And, under the theory, Todd has his original \$6,000 and \$500, making a total of \$6,500, the market value of what he expected had the contract been formed. Most importantly, the Honda has found its way to the person who values it the most. This argument supports

32. It is impossible to create a precise taxonomy of ways scholars have argued about expectancy, efficiency breach, and various remedies. It makes more sense to think in terms of questions presented: Is expectancy efficient? If it is, is it possible to produce the correct measure of expectancy? Are other remedies more consistent with efficiency? Should contract remedies be constructed to achieve the so-called efficient breach? Is there a moral basis for enforcing contracts that transcend efficient interests?

33. Below, a variation of this simple model is presented that involves different facts and additional complexities.

34. Why sell a car with a \$6,500 market value for \$6,000? Selling it at the market price may involve significant inconvenience, advertising, etc. That extra effort may not be worth it to the seller.

35. There surely are other red Hondas at a price of \$6,500 or even less, but Felix may not want to incur the inconvenience of searching and comparing.

36. It is useful to note that in this example the automobile already exists, Jane is not a producer, and all costs of production have been absorbed. This is to be compared to the second example. See *infra* Subsection I.A.2.

37. This may be less obvious for Felix, but he would not have paid \$8,000 for the car unless he attributed even greater value to it.

disallowing punitive damages in contract because awarding punitive damages would raise the price of a breach and discourage it when it would be efficient to breach. Conversely, a reliance measure of recovery³⁸ will understate the harm and encourage breaching too frequently.

2. Model 2

Many readers will recognize this example as based on the contracts casebook standard, *Peevyhouse v. Garland Coal & Mining Co.*³⁹ It is altered here a bit, and the importance of the example will not be evident until specific performance is discussed.⁴⁰ Willie and Lucille Peevyhouse contract with Garland Coal.⁴¹ Under the terms of the contract, Garland Coal is permitted to strip mine the Peevyhouse land.⁴² In return, the Peevyhouses receive royalties and, at the end of the process, Garland Coal agrees to restore the land.⁴³ Restoration will cost \$29,000, but the land will only be worth \$300 more than it would be if it were not restored, and the Peevyhouses are only interested in the resale value of the land.⁴⁴ Garland Coal breaches the contract and pays the Peevyhouses \$300.⁴⁵ Why is this efficient? First, the Peevyhouses have what they bargained for. They have land plus \$300 that offsets the decrease in value caused by its stripped condition. Garland Coal is actually better off. It pays only for the damages it caused. Perhaps more importantly, \$29,000 in resources is not used to create value of only \$300.⁴⁶

B. Internalization

Notice in both models, the breaching party has caused the non-breaching party to suffer a loss. There is no principled distinction between the harm or *externality* resulting from the breach and the externality in more typical examples of polluting factories or careless drivers. Moreover, to ensure efficient levels of production, producers must internalize their costs of production.⁴⁷ Harm caused to others is no less a cost of production than

38. In the example, no information about possible reliance is provided.

39. 382 P.2d 109 (Okla. 1962).

40. See *infra* notes 194-99 and accompanying text.

41. *Peevyhouse*, 382 P.2d at 110-11.

42. *Id.* at 111.

43. *Id.*

44. See *id.* at 111-12.

45. *Id.* at 110, 114.

46. The perceptive reader will note that the possibility that the Peevyhouses attribute value to the restored land beyond its resale value has not been raised at this point. This would have an important impact on efficiency.

47. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 41 (3d ed. 2000).

labor or raw materials. It is on the bases of those costs that firms determine their output and the price of that output.⁴⁸

As an example, suppose a producer regularly emits pollutants that lead to disease and medical expenses for those affected. That is a cost of production as much as electricity, wages, and raw materials. If those costs are not recognized (internalized), the producer will assume its costs of production are lower than they are. It will produce at inefficiently high levels and charge prices that are artificially low.

In the first of the two examples, the internalization by Jane will not alter her level of production, but the internalization is necessary nevertheless to ensure that her breach actually is consistent with the car finding its way into the hands of someone who values it more than Todd. In the second case, internalization is necessary not only to ensure the efficient breach but also to make sure *downstream* customers—in this case the buyers of coal—pay a price that signals the actual costs of production.⁴⁹

Although the emphasis is typically on compensating the non-breaching party,⁵⁰ that is not necessary for the efficient breach to occur. As an economic matter, all that efficiency requires is that the cost be recognized or internalized by the breaching party. It is, after all, the breaching party to whom the “correct” signal must be transmitted. Thus, regardless of to whom the \$500 is paid, Jane must factor in the \$500 cost of her breach. Similarly, Garland Coal only need realize that it will pay \$300 for its breach. Economics does not supply a basis for saying the amount internalized must end up in the hands of the person injured. After all, perhaps it would bring greater happiness or utility to someone next door or the people at a local homeless shelter. To whom damages are paid is a distributive issue and, for the most part, there is no *economically* correct distribution.⁵¹ Nonpayment may not seem fair to most, but that is a conclusion based, in large part, on moral as opposed to economic considerations.

48. There are graphical representations of this process found in most economics books. See, e.g., JEFFREY L. HARRISON, *LAW AND ECONOMICS IN A NUTSHELL* 197-99 (5th ed. 2011).

49. A firm that does not internalize fully will charge a lower price. Thus, the price will not reflect the actual resources used in production. In effect, consumers will buy items at prices that do not justify the use of resources in the production of what is purchased.

50. See *supra* text accompanying note 23.

51. Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549, 550-52 (1939).

II. DECONSTRUCTING EXPECTANCY

A. What Efficiency?

As noted, the idea that expectancy leads to efficient breaches came under attack over thirty years ago.⁵² Much of that criticism is based on the practical point that determining the correct measure of harm is complex. There are attorney's fees, uncertainty, and a variety of other factors to consider.⁵³ Thus, these arguments are principally about the unobtainability of true expectancy awards.⁵⁴ These practical considerations are related to a more important question: what exactly do we mean when discussing "efficiency" in the context of expectancy?

In economics, there are a variety of types of efficiency.⁵⁵ In the field of welfare economics, the relevant subfield for law and economics, three have at one time or another been the acceptable standards: utilitarianism, Pareto efficiency, and Kaldor-Hicks efficiency or Wealth Maximization.⁵⁶ As a historical matter, the measure of efficiency has changed for good reason but, in reality, all forms are flawed. Utilitarianism seeks to maximize well-being or happiness.⁵⁷ Most readers are familiar with the perceived deficiencies of utilitarianism and, therefore, efficiency standards based on maximizing utility. There are issues of utility monsters, questions of whether the aim is average total utility, and so on.⁵⁸ The biggest issue is that we cannot know if something is efficient from a utilitarian perspective because it is impossible to make interpersonal comparisons of utility.⁵⁹ For example, in the first hypothetical, both Jane and Felix must have increased their own utility; otherwise they would not have changed their positions. In effect, they were each involved in *intrapersonal* comparison and each felt happier with the outcome of the breach and resale.⁶⁰ We cannot be so sure about Todd. Is Todd

52. See *supra* note 11 and accompanying text.

53. See, e.g., Craswell, *supra* note 30, at 637.

54. Farber, *supra* note 1, at 1444.

55. See generally HARRISON, *supra* note 48, at 34-51. For a detailed and far-reaching analysis, see RICHARD S. MARKOVITS, TRUTH OR ECONOMICS 48-62 (2008).

56. See HARRISON, *supra* note 48, at 34-51; MARKOVITS, *supra* note 55, at 48-62.

57. See R.M. HARE, FREEDOM AND REASON 118-34 (1963); J.J.C. SMART & BERNARD WILLIAMS, UTILITARIANISM: FOR AND AGAINST 27-28 (1973).

58. HARE, *supra* note 57, at 118-34; WILLIAM H. SHAW, CONTEMPORARY ETHICS: TAKING ACCOUNT OF UTILITARIANISM 31-32, 119-20 (1999); SMART & WILLIAMS, *supra* note 57, at 27-28.

59. MARKOVITS, *supra* note 55, at 120. As an example, we cannot know whether the disutility caused by taxation is offset by the utility experienced by those who use a publicly maintained highway system.

60. On the other hand, their decision may turn out to be wrong, which is another complexity expectancy supporters tend to ignore. See *infra* notes 89-95 and accompanying text.

exactly as happy with the \$500 as he would have been with the car? There is no way to know. More importantly, if he feels worse off, does the increased utility enjoyed by Felix and Jane offset the decline in Todd's? No one suggests this comparison can be made.

This realization made another kind of efficiency better suited for welfare economics. The notion of Pareto efficiency eliminated the problem of interpersonal comparisons of utility.⁶¹ For a breach or any redistribution to be Pareto superior, all those involved and any third parties must be in a better position or a position that is no worse than before the change.⁶² The best way to assess whether this outcome has occurred is by determining if all those involved have or would have consented to the change.⁶³ This cannot be the "efficiency" referred to when expectancy is applied because, in the hypothetical, Todd has not consented; it is impossible to know if he is better off. If he voluntarily agrees to accept damages instead of the car, it would be a different matter. In the hypothetical, however, the breach is forced upon him.

Obviously, whether all parties would have consented or were at least indifferent is a heavy burden for any changes based on Paretian standards of efficiency. It does protect individual autonomy but at the expense of a great number of redistributions that may seem fair or even utility enhancing from a common sense perspective.⁶⁴ At the extreme, a small tax could not be imposed on even the wealthiest person for the purpose of relieving the pain of the poorest. In fact, any transfer of wealth by government action would fail the test. By the beginning of the Twentieth Century, due in large part to the failings of utilitarianism and Paretian standards, there was a serious question of whether welfare economics had anything useful to say for policy makers.⁶⁵

In the midst of this lack of direction, two economists, Kaldor and Hicks, essentially cobbled together a substitute notion of efficiency.⁶⁶ It is

61. See Jeffrey L. Harrison, *Piercing Pareto Superiority: Real People and the Obligations of Legal Theory*, 39 ARIZ. L. REV. 1, 2 (1997).

62. A change is Pareto Superior if those involved are at least as well off as they were before the change. See *id.* at 2. A distribution is Pareto Optimal if there are no changes that would be Pareto Superior. See *id.* at 2 n.12.

63. *Id.* at 3.

64. See *id.*

65. See Kaldor, *supra* note 51, at 549.

66. The initial question was if utilities cannot be compared unless one makes the assumption that individuals are uniform in their preferences and the ability to sense happiness, what can economics offer with respect to policies? *Id.* at 549-50. To this, Kaldor answered:

[W]here a certain policy leads to an increase in physical productivity, and thus of aggregate real income, the economist's case for the policy is quite unaffected by the question of the comparability of individual satisfactions; since in all such cases

actually more of a stand-in for utilitarianism than for Paretianism⁶⁷ because it sidesteps the interpersonal comparison of utility problem by substituting monetary value for utility.⁶⁸ On the other hand, it does not remedy the deficiency of not knowing if anyone is actually better or worse off. In effect, resource allocation is efficient if those benefiting *could* compensate those made worse off.⁶⁹ Compensation itself is not necessary. In the case of a contract breach and payment of damages, compensation does occur, but there is no way to know whether the compensation is sufficient.⁷⁰ The amount the breaching party is required to internalize may or may not equal the amount of loss experienced by the non-breaching party.⁷¹ It should be exactly the amount that leaves the non-breaching party indifferent between performance and breach with the payment of damages.⁷²

B. Expectancy and Efficiency

It is unlikely that expectancy is consistent with any of these versions of efficiency. The reasons for this in the case of utilitarianism and Pareto standards are easy. From the standpoint of utility it is simply impossible to determine whether the gainers—Jane and Felix in the first example—are better off than the loser—Todd—as far as utility. Similarly, from a Paretian standpoint we cannot know if Todd would have consented to the breach even though he then received \$500.

It is most important to examine the Kaldor-Hicks standard since it is the most commonly used. Here the efficiency of expectancy is questionable

it is *possible* to make everybody better off than before, or at any rate to make some people better off without making anybody worse off.

Id. at 550. Hicks, writing three months later, applied the same notion to the special case of organizing an industry into fewer firms: “Before recommending in practice a policy of shutting down redundant firms, we ought to be sure that the full condition is satisfied; and we ought to be very sure that the discarded factors will in fact be transferred to more productive uses.” J.R. Hicks, *The Foundations of Welfare Economics*, 49 *ECON. J.* 696, 710-11 (1939); see also J.R. Hicks, *The Rehabilitation of Consumers’ Surplus*, 8 *REV. ECON. STUD.* 108, 111 (1941).

67. See Marco J. Jimenez, *The Value of a Promise: A Utilitarian Approach to Contract Law Remedies*, 56 *UCLA L. REV.* 59, 71 n.50 (2008).

68. See *id.* at 96. Efforts to square their notion of efficiency with Pareto standards have also been and seem to be implicit in some recent work. See RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 94-95 (1981). For the most part, it appears the moral claim for Kaldor-Hicks efficiency has not been compelling. See Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 *HOFSTRA L. REV.* 509, 534-40 (1980). In effect, Kaldor-Hicks efficiency fails to be utility maximizing, and it fails to protect individual autonomy.

69. The move to monetary value dampens the utility monster problem somewhat, but does not eliminate it. Jimenez, *supra* note 67, at 96.

70. Eisenberg, *Actual and Virtual Specific Performance*, *supra* note 1, at 977.

71. *Id.* at 977-78.

72. See *id.* at 979.

at best. To appreciate why, it is useful to understand the notion of the "contract curve."⁷³ The contract curve is all the price points that would leave two potentially contracting parties who are contemplating an exchange better off.⁷⁴ Rational actors would choose at least one of those points.⁷⁵ For example, going back to the original sale of the car by Jane to Todd, suppose the least Jane would take for the car is \$5,000 and the most Todd would pay is \$7,000. The contract curve is all the prices between those two amounts. Since the lowest Jane would take is \$5,000, at that price she is indifferent between selling and keeping the car or just barely in favor of selling it. In the original sale, the sum of \$6,000 is clearly on the contract curve.

Now think of an *ex post* contract curve. It could be after the original contract is made and before the car is delivered or, perhaps, even after performance. In either case, it reflects a period after Jane is presented with Felix's opportunity. Under the first scenario, suppose Jane receives Felix's offer just before she delivers the car and knows she will be forced to specifically perform the contract if she does not deliver the car to Todd. The contract curve extends from the least Todd would accept to relieve Jane of her obligation to the most Jane would pay. In the latter case, she has delivered the car and would like to buy it back in order to resell to Felix. Here the contract curve extends from the lowest amount Todd would accept for the car and the most Jane would pay.

Is there any reason to believe that \$6,500—assuming damages are \$500—is on the contract curve between Todd and Jane at this point? It must be for the \$500 expectancy to be efficient. There are at least three reasons to doubt that it is. Perhaps it would be efficient for Jane based on the profit that could be made if she could sell the car to Felix. The problem is at the other end of the curve. Todd's perception of himself has switched from that of a buyer to a seller. Why assume that \$6,500 is acceptable to Todd? There appears to be no good reason for that assumption. Indeed, a great deal of empirical research suggests that it would be the wrong assumption.

First, since Todd has moved from buyer to seller he may very well be affected by what behavioral economists call the endowment effect.⁷⁶ What

73. A derivation of the contract curve can be found at JEFFREY L. HARRISON & JULES THEEUWES, *LAW & ECONOMICS* 185-89 (2008).

74. *Id.* at 189.

75. *See id.*

76. The endowment effect is related to what is often called the wealth effect. *See* Russell Korobkin, Note, *Policymaking and the Offer/Asking Price Gap: Toward a Theory of Efficient Entitlement Allocation*, 46 *STAN. L. REV.* 663, 689 (1994). The wealth effect occurs when how much someone is willing to pay or accept for an item is determined by his or her wealth. *See* Elizabeth Hoffman & Matthew L. Spitzer, *Willingness to Pay vs. Willingness to Accept: Legal and Economic Implications*, 71 *WASH. U. L.Q.* 59, 85-87 (1993). The endowment effect takes this phenomenon one step further and describes situations in which people value something more when they own it than when they do not own it. *See id.* at 89; Jack L.

sociologists and behavioral economists have determined is that people can attribute different values to the very same thing depending on whether they perceive it as belonging to them.⁷⁷ Once the contract is made, Todd may feel that the car is essentially his, and comparing his valuation after the contract is a different matter than simply averaging the selling price of cars.

Second, and putting aside the fact that Todd is different before and after the contract, there is the disconnection between the market value and a point on the contract curve for any particular person. Would the amount that would be paid in damages and which corresponds to market value be on the contract curve? The question again is why this assumption would be made. The market value is an average. This means approximately half the sales of a comparable car took place at a higher price and half at a lower price.⁷⁸ It is quite possible that the contract curve for a number of people did not extend as low as \$6,500. More importantly, it tells us that we have no idea how much Todd valued the car, and awarding him an average is a bit like giving everyone who walks into a clothing store a medium sized shirt and then assuming it fits.

Third, suppose \$6,500 appears to be on the Todd/Jane contract curve in that it would be exactly the equivalent of the minimum amount necessary for Todd to buy a replacement car and cover any incidental expenses. Does this mean that Jane has fully internalized the harm caused by the breach if she is forced, through expectancy, to compensate Todd at this amount? This is a closer question and may depend on exactly what is defined by the contract curve. Behavioral economics tells us that it is entirely possible that points that would *appear* to be on the contract curve may be objected to by Todd because they do not conform to his sense of fairness.⁷⁹ This can be

Knetsch & J.A. Sinden, *Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value*, 99 Q.J. ECON. 507, 516 (1984); Korobkin, *supra*, at 688-91. This appears to be independent of the overall impact of owning the item on one's actual wealth. In both cases, there is a difference between what people are willing to offer for an item and what they would accept to sell the item. See Hoffman & Spitzer, *supra*, at 87-91; Korobkin, *supra*, at 688-97.

77. Hoffman & Spitzer, *supra* note 76, at 87-91; Knetsch & Sinden, *supra* note 76, at 516-18; Korobkin, *supra* note 76, at 688-97.

78. What is actually described here is the median. Market value is the mean, and to be precise, there is no assurance that half of the prices are above this amount and half are below.

79. See Jeffrey L. Harrison, *Class, Personality, Contract, and Unconscionability*, 35 WM. & MARY L. REV. 445, 468-80 (1994). Technically, the contract curve has all the points that lie between the most a buyer would pay and the least a seller would take. *Id.* at 474. Whether a sense of justice actually narrows the conventional curve depends on one's view of the curve. *Id.* Conventional representations do not allow for situations in which an amount would seem to make the buyer or seller better off but is unacceptable because of the issues discussed here. Nevertheless, whether regarded as a deviation from the contract curve or a conventional contract curve, the point is that this sense of justice narrows the range of acceptable prices. See *id.*

understood by reference to ultimatum games. In these two person games, Party One is given a sum of money and may keep it if Party Two agrees. The idea is that the original party will offer some portion of the initial amount in order to get permission from the other party. They have only one chance to do this, and there is no communication. From an economic perspective, offering a penny or even nothing should do the trick.⁸⁰ Even if Party One offers nothing, Party Two is no worse off, and even if a very small amount is offered, Party Two is better off. The actual experiments suggest something different. In fact, those in the position of Party One typically offer more than the minimum, and those in the position of Party Two reject very low offers. In a sense, the lowest that is acceptable (even though it might appear to be on a hypothetical contract curve) is not at the low point of the contract curve.⁸¹ Put in the context of the hypothetical, the least Todd would take it is higher than the minimum necessary for Todd to buy the substitute car and cover any other losses.

One possible way to bring expectancy back into line with efficiency is to assume away any factors that may cause a difference.⁸² For example, assume the breach involves a fungible good.⁸³ The widget, of which there is no shortage in legal scholarship, is a possibility.⁸⁴ One widget is like any other. As long as the non-breaching party receives damages that allow him or her to acquire widgets, how could a breach not be efficient?⁸⁵ Under this scenario, there is no performance, but a check arrives with a note and the recipient has no reaction. In other words, the check is a perfect substitute for performance—the recipient has no preference for a particular supplier, and the breaching party has included in the check compensation for all incidental and consequential damages. This compensation would have to extend to presumably beneficial activities put aside while a covering transaction takes place. The possibility a buyer is completely indifferent between actual performance and “performance” in the form of notice of breach and a check

80. RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 22 (1992); Daniel Kahneman, Jack L. Knetsch & Richard Thaler, *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728, 736 (1986); Richard H. Thaler, *Anomalies: The Ultimatum Game*, 2 J. ECON. PERSP. 195, 196 (1988). The possibility of zero can be understood by remembering that the Party Two is no worse off if he receives nothing, and Party One is better off meaning the outcome is consistent with Paretian and, possibly, utilitarian standards.

81. Again, this depends on one's preference about how to view the contract curve but is irrelevant with respect to the analysis.

82. See Markovits & Schwartz, *supra* note 1, at 1950-51.

83. *Id.* at 1954.

84. According to a Westlaw search, the term widget has been used over 5,000 times by articles found in the “TP-ALL” database.

85. This would have to include all possible sources of injury. Naturally, in contract law, this is subject to a foreseeability limit. The inexactness of foreseeability is another source of difference between expectancy and full internalization.

seems unrealistic.⁸⁶ Indeed, Professor Melvin Eisenberg argues that “damages under the [expectancy theory] always fall short of making a promisee indifferent between performance and legal relief.”⁸⁷

Another factor that makes the efficient breach idea elusive involves a different perspective altogether and focuses on the breaching party. Again, the party receives a check for damages and has no reaction—the check is as good as performance. The problem is that sometimes this may be better than performance—the breach is a blessing, and expectancy based on market value *overcompensates*. Here again the breach is not efficient because the amount internalized is too much. How is this possible? When making the contract, the non-breaching party understood that he or she would be held to the bargain. The risk of buyer’s or seller’s remorse had been assumed. The arrival of the letter breaching the contract and the check, if it truly is expectancy, is a windfall. The breaching party has actually bestowed an unexpected option on the non-breaching party. At the point of the breach and with check in hand, the non-breacher has a second chance to evaluate the options, this time with the benefit of further information. No doubt some non-breaching parties will regard the second chance as worthless and others will be quite delighted.

C. Happiness and Efficiency

In the above analysis, there is an underlying assumption that efficiency represents a single discoverable amount.⁸⁸ The teachings of happiness studies⁸⁹ over the last several years make it clear that the question of com-

86. See generally Farber, *supra* note 1.

87. Eisenberg, *Actual and Virtual Specific Performance*, *supra* note 1, at 977.

88. See *supra* Section II.B.

89. See generally ROBERT H. FRANK, CHOOSING THE RIGHT POND: HUMAN BEHAVIOR AND THE QUEST FOR STATUS (1985); BRUNO S. FREY & ALOIS STUTZER, HAPPINESS AND ECONOMICS: HOW THE ECONOMY AND INSTITUTIONS AFFECT WELL-BEING (2002); DANIEL GILBERT, STUMBLING ON HAPPINESS (2006); INTERPERSONAL COMPARISONS OF WELL-BEING (Jon Elster & John E. Roemer eds., 1991); JONATHAN HAIDT, THE HAPPINESS HYPOTHESIS: FINDING MODERN TRUTH IN ANCIENT WISDOM (2006); JENNIFER MICHAEL HECHT, THE HAPPINESS MYTH: WHY WHAT WE THINK IS RIGHT IS WRONG (2007); RICHARD LAYARD, HAPPINESS: LESSONS FROM A NEW SCIENCE (2005); MATTHIEU RICARD, HAPPINESS: A GUIDE TO DEVELOPING LIFE’S MOST IMPORTANT SKILL (Jesse Browner trans., Little, Brown & Co. 2006) (2003); Jeremy A. Blumenthal, *Law and the Emotions: The Problems of Affective Forecasting*, 80 IND. L.J. 155 (2005); Richard A. Easterlin, *Explaining Happiness*, 100 PNAS 11176 (2003); Richard A. Easterlin, *Income and Happiness: Towards a Unified Theory*, 111 ECON. J. 465 (2001); Richard A. Easterlin, *Will Raising the Incomes of All Increase the Happiness of All?*, 27 J. ECON. BEHAV. & ORG. 35 (1995); Tiffany A. Ito & John T. Cacioppo, *The Psychophysiology of Utility Appraisals*, in WELL-BEING: THE FOUNDATIONS OF HEDONIC PSYCHOLOGY 470 (Daniel Kahneman, Ed Diener & Norbert Schwarz eds., 1999); Richard E. Lucas et al., *Reexamining Adaptation and the Set Point Model of Happiness: Reactions to Changes in Marital Status*, 84 J. PERSONALITY & SOC. PSYCHOL. 527

pensation is far more complicated. It may, in fact, make any workable notion of efficiency, and therefore the efficient breach, unobtainable.⁹⁰ To understand the problem, it is important to note that modern notions of efficiency are assessed at the time decisions are made.⁹¹ Take a simple example and assume rationality by both parties. Jack offers a book for sale for \$20. The implication is that John expects anything he can use the \$20 for will yield greater than or the same utility as the book. Diane buys the book at that price. At that point she believes the book will result in the same or more utility than anything else that can be purchased for \$20. When the parties make this decision they are acting on *decisional* utility—how they *think* they will feel after the exchange.⁹² There would be no contract if that anticipated state were not superior to the *status quo*.

Studies indicate that experienced utility—what actually happens—can be different from decisional utility.⁹³ A few days after the exchange, Diane may wonder why she paid \$20 for a book she dislikes. And Jack may realize, too late, that he took a lot of pride in having that book in his collection. The problem is that if efficiency is about actual utility, then decisional utility is an imperfect substitute. The difference between decisional and experienced utility can mean simply that things do not turn out as expected. One factor that seems to play tricks with utility is the passage of time.⁹⁴ One may experience something that is quite unpleasant and then take great pride in having survived the experience. In effect, an experienced disutility can lead to utility as one reflects on the experience. Conversely, something very enjoyable at the time may turn out to be regretted.

The possibility that traditional measures of efficiency are, at best, measures of anticipated utility means that the amount internalized by a

(2003). For an excellent selection of readings, see generally WELL-BEING: THE FOUNDATIONS OF HEDONIC PSYCHOLOGY, *supra*.

90. See sources cited *supra* note 89.

91. This notion can be traced to Paul Samuelson's concept of revealed preference. Samuelson noted that we can only know what makes people better off by observing the choices they make. Paul A. Samuelson, *Consumption Theory in Terms of Revealed Preference*, 15 *ECONOMICA* 243 (1948); Paul A. Samuelson, *A Note on the Pure Theory of Consumer's Behaviour*, 5 *ECONOMICA* 61 (1938). This was not always characteristic of utilitarianism. Bentham viewed the question as more in line with what was actually experienced. JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION 2 (Dover Publ'ns 2007) (1780). Thus, "[b]y utility is meant that property in any object, whereby it tends to produce benefit, advantage, pleasure, good, or happiness . . . or . . . to prevent the happening of mischief, pain, evil, or unhappiness." *Id.*; see also GEOFFREY SCARRE, UTILITARIANISM 72-81 (1996).

92. See generally Daniel Kahneman, Peter P. Wakker & Rakesh Sarin, *Back to Bentham? Explorations of Experienced Utility*, 112 Q.J. ECON. 375 (1997).

93. Daniel Kahneman, *Objective Happiness*, in WELL-BEING: THE FOUNDATIONS OF HEDONIC PSYCHOLOGY, *supra* note 89, at 3, 17.

94. See generally *id.*

breaching party may or may not offset the disutility caused by the breach. For example, in the Honda hypothetical, suppose Jane does breach and writes a check to Todd who is actually indifferent between the car and damages. He then combines his \$6,000 (remember there was no prepayment) with \$500 and buys a substitute car. It turns out to be a disappointment, not because of the car itself, but because Todd way overestimated how much he would enjoy the car. In fact, the original contract, as experienced, would not have been efficient in any meaningful sense because Todd made a mistake. Paying Todd \$500 is based on *decisional* utility, which he now knows was mistaken. A remedy based on actual or experienced utility could be quite different and would reflect an accurate level of internalization.

In addition, although controversial, some examinations of happiness suggest that, whatever heightened sense of utility or disutility someone experiences, his or her sense of well-being tends to return to a set point level of happiness.⁹⁵ If so, Todd may be beside himself when Jane does not deliver the car. In a week he may not care that much, and in a month the breach may be but a faint memory. How much should Jane internalize in such a case? Obviously one cannot equate utility with dollars in the first place, but it is even more difficult when utility or disutility may spike for some people but remain constant for others.

D. Moral Objections

As noted in the Introduction, this Article does not take on the independent issue of the morality of breaching.⁹⁶ At least in theory, moral objections or ones based on principle are not ones that can be eliminated by compensating the person who is morally offended.⁹⁷ Promise breaking or breach of contract may be, for some, morally objectionable in the sense that compensation is not a substitute for not keeping a promise. On the other hand, a breach of contract can elicit a number of negative psychological reactions, some of which may be viewed as morality-based but which can also be partially offset by compensation.⁹⁸

95. See Phillip Brickman & Donald T. Campbell, *Hedonic Relativism and Planning the Good Society*, in ADAPTION-LEVEL THEORY 287 (M.H. Appley ed., 1971); Andrew J. Oswald & Nattavudh Powdthavee, *Death, Happiness, and the Calculation of Compensatory Damages*, in LAW AND HAPPINESS 217, 221 (Eric A. Posner & Cass R. Sunstein eds., 2010); Peter A. Ubel & George Loewenstein, *Pain and Suffering Awards: They Shouldn't Be (Just) About Pain and Suffering*, in LAW AND HAPPINESS, *supra*, at 195, 196.

96. See *supra* note 18 and accompanying text.

97. In cases in which compensation is not adequate, one can view the moral value as having lexical priority.

98. See sources cited *infra* note 99. As a baseline, consider someone who is *morally* offended by a breach, whether it involves one of his or her own contracts or that of another person, and is without regard for the damages awarded. This objection is based on principle.

For practical purposes, there may not be an easy way of separating moral objections from objections based on personal disutility.⁹⁹ For example, a breach may be regarded as unfair, unjust, exploitative, or even anger inducing. All of these feelings are negative—certainly no one prefers to feel they have been treated unfairly or exploited. This disutility is no less a negative externality than any other, and in theory, an efficient remedy accounts for these negative feelings.¹⁰⁰ The point is that if expectancy is to be efficient, it must address both types of “moral” objections. It cannot, however, address *pure* moral objections at all. In addition, a remedy that returns the person whose “moral” objections are compensable to a point of indifference may not be impossible in theory but, in practice, cannot be based on much more than a guess.

E. Uncertainty

A final note is in order that pertains to timing and uncertainty. For the most part when expectancy and efficient breach are discussed, the situation is one in which there are no complications. The amount of expectancy is easily determined, and there is no uncertainty about whether a breach has occurred.¹⁰¹ As soon as the possibility of a trial arises, the analysis shifts.¹⁰² First, the perception by both parties shifts from a certain recovery or payment to an expected recovery, which is the probability of prevailing times the expected recovery.¹⁰³ Second, disputes about whether expectancy is due at all means incurring transaction costs. These costs may eventually outweigh any gain associated with redirecting the good or service involved to

In the purest sense, a moral objection is not one that evaporates if compensation is high enough. Indeed, it is hard to view an objection as morality based if it were possible for a sufficient damages award to render the person indifferent between a breach and performance.

99. The difficulties of making this distinction is suggested by studies reported on by Wilkinson-Ryan & Baron, *supra* note 17, at 423; see also Eisenberg, *Actual and Virtual Specific Performance*, *supra* note 1, at 1008-10; Frank Menetrez, *Consequentialism, Promissory Obligation, and the Theory of Efficient Breach*, 47 UCLA L. REV. 859, 877-78 (2000); Tess Wilkinson-Ryan, *Do Liquidated Damages Encourage Breach? A Psychological Experiment*, 108 MICH. L. REV. 633, 637 (2010).

100. Moreover, the person may feel less disutility if sufficient damages are awarded. Certainly, it may vary with the moral sensitivities of the non-breaching party.

101. See, e.g., A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 31-33 (2d ed. 1989); COOTER & ULEN, *supra* note 47, at 189-90; E. ALLAN FARNSWORTH ET AL., CONTRACTS: CASES AND MATERIALS 20-22 (7th ed. 2008). This is not to suggest the authors cited here do not understand the complexity, but the starting analysis is typically one that omits much of reality.

102. For a discussion of the impact of risk and different attitudes toward risk on contract breach, see generally Alex Y. Seita, *Uncertainty and Contract Law*, 46 U. PITT. L. REV. 75 (1984). See also Farber, *supra* note 1, at 1444.

103. Ultimately, expected costs have to be included in the decision-making process.

its more valued use.¹⁰⁴ In fact, once there is any disagreement about whether there is a breach and what the damages are, costs begin to offset whatever was efficient about the breach in the first place.¹⁰⁵

This means, if one returns to the hypothetical, when Jane hears of Felix's offer she may not think, "If I write a check to Todd for \$500, he will have no complaints, and I will profit." Instead, the thought process might be something like this:

If I breach, Todd may not take \$500. In fact, I could be in a trial that will be a headache, and I may pay more or even less than \$500. In addition, if word gets out, it may mean my reputation is harmed, and I will have a tougher time selling cars in the future so maybe I should offer Todd not just \$500 but some additional amount to say good things about me (or at least not leave negative feedback on eBay). In fact, if we go to trial and he has convincing expert witnesses, I may pay much more.

Given these circumstances and uncertainties it is often difficult to understand, based only on this small dose of reality, what forty years of discussion and debate about efficiency and expectancy have achieved in terms of guidance for those who actually apply contract law.¹⁰⁶ An amount that will achieve expectancy is only relevant in the context of several other variables. The concept of a single treatment¹⁰⁷ for all types of breaches in all circumstances is an illusion primarily found only in legal scholarship.

F. False Positives, False Negatives, Incorrect Signals, and Downstream Effects

When expectancy damages are less than fully compensatory, it creates a false *positive* signal that a breach is efficient. It is a false *negative* when overcompensation occurs. This is all fairly obvious, but the importance has not been fully explored. To understand the impact of false positives, consider the altered *Peevyhouse* case described above.¹⁰⁸ As casebook readers will recall, the *Peevyhouses* eventually recovered \$300 for the breach.¹⁰⁹ Again though, assume they valued the restoration of the land at \$29,000.¹¹⁰ As noted in the Introduction, the compensation to the non-breaching party is

104. See Farber, *supra* note 1, at 1444.

105. See *id.*

106. This is not to say that there are not excellent articles on the complexities. In particular, works by Richard Craswell, *supra* note 30, and Daniel Farber, *supra* note 1, are excellent and early sources pointing out how difficult it is to put the notion of efficient breach into practice.

107. As will be illustrated below, the illusion of the single remedy solution also extends to specific performance. See *infra* text accompanying notes 192-205.

108. See *supra* Subsection I.A.2.

109. *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109, 114 (Okla. 1963).

110. See *supra* text accompanying note 44.

the price the breaching party pays in order to breach and the cost it internalizes.¹¹¹ It is, thus, as much a cost of operating the business as paying for labor or materials. For prices and output to be efficiently set in downstream markets, the parties selling in those markets should internalize all costs of production.¹¹² Otherwise, economists say that production in those markets is at allocatively inefficient levels.¹¹³ In effect, the price charged for the downstream output, which is itself a function of costs of production, will send an incorrect signal to buyers. In the *Peevyhouse* scenario, as altered here, a \$300 award results in a false positive in the sense that the correct signal to Garland would be that the land should—from an economic standpoint—be restored. Garland Coal does not pay the actual cost of its breach but a much lower amount. Not only will the inefficient breach occur, but Garland Coal is likely to charge lower prices and sell higher quantities in the markets in which it sells than would be the case if they paid \$29,000 in connection with restoring the land. In fact, coal would be underpriced relative to other fuels whose sellers do internalize all costs of production. This is the same analysis that would apply in the case of non-payment for any input. There are, to be sure, a number of conditions that must be fulfilled to achieve efficiency in output markets,¹¹⁴ but, even if those were satisfied, the downstream impact of false positives would prevent prices and quantities from adjusting to allocatively efficient levels.

Changing some of the assumptions above alters the outcome only slightly. Suppose now that the land can still be restored for \$29,000. The Peevyhouses, however, only feel \$15,000 worse off with unrestored land, and the diminution in value remains at \$300. The damage to be internalized would be \$15,000. In this case, unless third parties are negatively affected, it would be inefficient to restore the land and it would not be restored—Garland would still breach and pay a price for its breach that is well below

111. See *supra* text accompanying note 28.

112. See *supra* text accompanying notes 47-48.

113. Allocative efficiency can be understood by noting that people place a certain value on goods or services. HARRISON & THEEUWES, *supra* note 73, at 22. The production of those goods and services involve the use of inputs purchased by producers. *Id.* at 23. Those inputs have uses in the production of goods and services but are allocatively efficiently used when drawn into their most valued uses. See *id.* Output is allocatively efficient as long as the value attributed to the goods and services exceeds the costs of the inputs. See *id.*

114. For a market to achieve allocative efficiency, input markets must be highly competitive. In reality this is unlikely, leading to the possibility that the best to hope for are “second best” solutions. See Richard S. Markovits, *A Basic Structure for Microeconomic Policy Analysis in Our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics*, 1975 WISC. L. REV. 950, 953. In effect, miscalculation is one of many factors that prevent allocative efficiency. The most common cause is variations in the competitiveness of input markets. For an example, see HARRISON, *supra* note 48, at 32-35. Nevertheless, even if all other factors were consistent with allocative efficiency, damage inaccuracies would prevent it from being obtained.

the cost of that breach to the Peevyhouses. Again the same incorrect signal with respect to Garland's cost of production is sent to downstream markets. Garland Coal pays \$300 for an activity (or lack thereof) that is worth \$15,000. The savings are reflected in pricing and again the wrong signal is sent to purchasers.

As a final possibility, consider the case when expectancy damages are set at a level higher than necessary to compensate. In effect, the price paid for the breach exceeds the cost to the non-breaching party. In this case, the Peevyhouses may feel only \$15,000 worse off with unrestored land, the cost of restoration is \$29,000 and their recovery is \$20,000. A breach may still occur, and it is hardly a false positive since the price of the breach exceeds the cost. On the other hand, the label "false negative" is also not quite accurate since Garland Coal will still find it in its interest to breach. Nevertheless, the misallocations at the downstream level still occur. The breaching party pays more for the "input," which is, of course, the breach. Prices increase in the downstream market and output declines. Again, when faced with higher prices, buyers may shift to other producers. It is possible these producers are less efficient than the higher-priced supplier who has paid supracompensatory damages.¹¹⁵

G. Summary

In 1981, just after full development of the concept of the efficient breach,¹¹⁶ Ian Macneil wrote his powerful article, *Efficiency Breach of Contract: Circles in the Sky*.¹¹⁷ While his reasoning does not quite support his arguments that the efficient breach is a "fallacy,"¹¹⁸ the notion of "circles in the sky" seems appropriate.¹¹⁹ Could a breach occur that results in an efficient outcome? The answer appears to be yes, but there are so many contingencies that it almost certainly is a rare occurrence and coincidence more than a rational application of a system of remedies. Indeed, it is not clear that anyone could actually identify when the efficient breach has occurred. Moreover, even if the breach is efficient, the cost (damages) may be incor-

115. This does not exhaust the ways of criticizing expectancy as a means of encouraging the efficient breach. Richard Craswell was perhaps the first and most thorough scholar to list the number of practical hurdles between efficiency and expectancy. See Craswell, *supra* note 30, at 661-65.

116. See *supra* text accompanying notes 5-6, 11.

117. See generally Macneil, *supra* note 11. See *infra* notes 130-58 and accompanying text.

118. See Macneil, *supra* note 11, at 950-53. The fallacy to which Professor Macneil is referring is not clear. It may have been more appropriate to refer to it as "the fallacy of expectancy."

119. *Id.* at 947.

rect.¹²⁰ An incorrect amount is internalized and downstream inefficiencies occur.¹²¹

III. THE EXPECTANCY/SPECIFIC PERFORMANCE/LIQUIDATED DAMAGES/PUNITIVE DAMAGES DISCUSSION

The focus of this Part is specific performance and its surrogates. A discussion of specific performance invariably also includes additional discussion of expectancy. The two topics cannot be separated as neatly as the heading may suggest. The first two Sections introduce the complexity of attempting to support either expectancy or specific performance as superior as the means to the end of the efficient breach.¹²² The next two Sections return to the use of the contract curve to demonstrate why specific performance is not, and probably cannot be, viewed as the superior alternative.¹²³

As noted in the Introduction, one aspect of the efficient breach debate is whether specific performance or expectancy damages are more consistent with the efficient breach.¹²⁴ Although impossible to quantify, it appears as a general matter that, at least among scholars, specific performance is increasingly favored.¹²⁵ But this is fluid. One important work seems to argue in favor of specific performance “sometimes.”¹²⁶ Another leading strong proponent of specific performance has recently signaled at least some doubts.¹²⁷

A. Specific Performance and Expectancy

Foremost among those who initially questioned expectancy as leading to efficient breach were Professors Peter Linzer, Ian Macneil, and Daniel Farber.¹²⁸ Professor Linzer, commenting on the Restatement (Second) of Contracts and the amoral nature of contract law, pointed out that the efficient breach was seriously flawed when subjective values were at stake.¹²⁹ Professor Macneil’s criticism is broader, harsher, and worthy of a close

120. See *supra* Section II.B-F.

121. See *supra* Section II.F.

122. See *infra* Section III.A-B.

123. See *infra* Section III.C-D.

124. See *supra* notes 13-15 and accompanying text. To be accurate, the general issue of the efficient breach has also included discussion of liquidated damages and punitive damages. See Dodge, *supra* note 1, at 683-85; Goetz & Scott, *supra* note 8, at 558-62.

125. See generally Douglas Laycock, *The Death of the Irreparable Injury Rule*, 103 HARV. L. REV. 688 (1990); FARNSWORTH, *supra* note 10, at 746-74.

126. See Eisenberg, *Actual and Virtual Specific Performance*, *supra* note 1, at 1029.

127. See *supra* note 16 and accompanying text.

128. See *supra* note 11 and accompanying text.

129. Linzer, *supra* note 11, at 111-12, 118-25.

look.¹³⁰ Farber catalogues the multitude of ways expectancy can fail to be compensatory and, consequently, is inconsistent with the efficient breach.¹³¹ More specifically, if expectancy were the rule, there are many reasons to believe that breach would take place at inefficiently high levels.¹³² The focus immediately below is on Professor Macneil's effort because he was among the first to begin the process of measuring expectancy alongside specific performance.¹³³ His analysis did not, for the most part, quibble with whether expectancy *could* be linked to efficiency. It is much more an argument about which remedy is more likely to be consistent with efficiency.¹³⁴

Professor Macneil worked from a hypothetical first introduced by Professor Linzer in which a party who is contractually obligated to make chairs is offered a far more lucrative opportunity to switch to the manufacture of tables.¹³⁵ The efficient outcome would be to switch to the production of tables.¹³⁶ Macneil observed, "The assumption that it is economically efficient . . . to build tables rather than chairs by no means leads to the conclusion that breach is the economically efficient result."¹³⁷ In what now seems like a simple observation, Professor Macneil noted that efficiency did not depend on breach but on the redirection of productive capacity.¹³⁸ This redirection could be reached without breach and without expectancy damages.¹³⁹ For example, assume the default remedy in the case of breach of contract is specific performance and return to the hypothetical of Jane, Todd, Felix, and the red Honda. After receiving the offer from Felix and understanding the outcome if she did breach, one would expect Jane to approach Todd and offer him part of the profit from the breach in order to be relieved of the obligation to deliver the car. According to Professor Macneil, there is no particular efficiency advantage of one rule over the other as long as there are no transaction costs.¹⁴⁰ When there are transaction costs, this conclusion changes and one rule will more readily lead to more efficient outcomes.¹⁴¹ But, he emphasizes, this is a different matter than the substance of the rule

130. See, e.g., Macneil, *supra* note 11, at 950. Professor Macneil's arguments are presented in unusually direct language. *Id.* It represents the disdain with which many conventional scholars regarded economic analysis at that time.

131. Farber, *supra* note 1, at 1448-68, 1476.

132. *Id.* Another way to state this is that expectancy does not result in the full internalization of the harm caused.

133. See sources cited *supra* note 11.

134. See Macneil, *supra* note 11, at 949-50.

135. See Macneil, *supra* note 11, at 948 (citing Linzer, *supra* note 11, at 114-15).

136. *Id.* at 950.

137. *Id.*

138. *Id.* at 950-51.

139. *Id.*

140. *Id.* at 951-53.

141. *Id.* at 954-60.

itself.¹⁴² The determining factor is which rule in any particular circumstance results in lower transaction costs.¹⁴³

Although the transaction cost analysis is correct in theory, it can be broken down to a more specific analysis focusing on the most likely types of disagreements that can occur even when a jurisdiction has a firm rule about the applicable remedy. Under this more refined analysis it appears, as far as transaction costs, expectancy may have the edge.¹⁴⁴ A place to start in order to understand this is a jurisdiction in which there is an ironclad expectancy rule and both parties know that and do not disagree about the amount of damages. In this case, the transaction costs will be very low. The breaching party will write a check and transaction costs will only involve the non-breaching party's efforts to enter into a covering transaction. In the same set of circumstances, suppose the ironclad remedy is specific performance. Now there must be a negotiation between the parties for the redirection of resources to occur. Owing to the bilateral nature of their relationship, the negotiation may be prolonged and the amount determined may or may not equal actual damages. In this case, it seems almost certain that the transaction cost analysis favors expectancy.

Moving from the simplest point, suppose the parties in the ironclad expectancy jurisdiction are exactly like they were above except there is a

142. *Id.* at 956.

143. Professor Macneil argues that the appropriate statement of the rule pertaining to efficient breach is as follows:

Whether an expectation damages rule or a specific performance rule is more efficient depends entirely upon the relative transaction costs of operating under the rules. Where, as will most generally be the case, transaction costs under either rule will exceed gross efficiency gains made possible by scrapping one contract in favor of another, each rule is equally (in)efficient. Where both rules will permit substituting a more productive contract for a less productive contract, the difference in efficiency of the rules will be measured exactly by the difference in their respective transaction costs. Where one rule will permit substitution and the other will not, the difference in efficiency will be measured by the difference in respective transaction costs, but subject to an upper limit consisting of the hypothetical net efficiency gain under the rule with the lower transaction costs. None of the transaction costs can be deduced by use of the microeconomic model, but can only be determined inductively from empirical evidence.

Id. at 957. It seems likely that Professor Macneil was not arguing for changing the "rule" in the case of each contract depending on the transaction costs. That would mean proceeding through litigation, which would almost certainly mean transaction costs would eliminate any gain associated with a breach. See Farber, *supra* note 1, at 1444. One reason this is unclear relates to the second sentence of the statement. Macneil, *supra* note 11, at 957. This is consistent with some of the examples he offers. He also lists as a cost the impact of breach on the reputation of the breaching party. *Id.* at 954-58. This also suggests some finding of wrongdoing.

144. See Markovits & Schwartz, *supra* note 1, at 1944-45. Of course, this assumes that either remedy will mean full internalization, which, as explained, is not the case. *Id.* at 1992-93.

disagreement about the amount of damages. This means there will be a negotiation, litigation, or both. The likelihood of an efficient breach declines because of these extra costs.¹⁴⁵ For example, the potentially breaching party will realize that there are costs beyond just writing the check. On the other hand, in the ironclad specific performance context, there will be no quibble over the damages, but the negotiation about the price of a release from the performance will be similar to that described above. Here again, there does not seem to be a transaction cost advantage to specific performance.

Third, this time the same parties disagree about whether there is a breach at all. In both jurisdictions, the parties will incur significant transaction costs. On the other hand, once liability and damages are determined under expectancy, a check is written. In the specific performance context, however, even after liability is determined, the costs of renegotiation are still to be incurred. And, as in the other examples, the process of bargaining around the order of specific performance may be costly and prolonged.

In short, at least from a general perspective and without empirical evidence, it appears that expectancy would be the lower transaction cost alternative in most instances. On the other hand, as described above and later, lower transaction costs do not assure an efficient breach when expectancy is the applicable remedy.¹⁴⁶ This leads to the question, addressed in the next section, of whether specific performance is superior in reaching the efficiency breach even though it may be the more costly remedy in terms of transaction costs. Transaction costs may block the efficient breach, but their absence does nothing to offset the inherent problems discussed in Section C.

First, however, it is useful to consider another of Professor Macneil's concerns which was the lack of attention by those then applying law and economics to the determination of the initial allocation of rights.¹⁴⁷ To understand why this is important, it is useful to recall the difference between liability rules and property rules.¹⁴⁸ Under a liability rule, examples of which are expectancy damages and recoveries based on torts, the remedy is compensation.¹⁴⁹ In torts, the remedy brings the party back to the position he was in before the damages. In contracts, the theory is that the injured party

145. See Farber, *supra* note 1, at 1444. Other things change here as well. Both parties are now bargaining about an expected loss or gain, and their tolerance for risk will affect the likelihood of settlement.

146. See *supra* Section II.C.

147. Professor Macneil mistakenly asserts that there is no efficiency standard applied to initial allocations and that they just exist and are viewed as neutral. Macneil, *supra* note 11, at 950-53. This is not completely accurate. An initial allocation can be Pareto optimal if there are no redistributions that would make at least one person better off while not making anyone worse off. Harrison, *supra* note 61, at 2 n.12; Macneil, *supra* note 11, at 953.

148. See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1106-10 (1972).

149. See *id.*

is put in the position he would have been had there not been a breach. Under a property rule, on the other hand, the rights may not be violated without permission. This distinction makes sense. In some cases, transaction costs are too high to expect the parties to meet and agree.¹⁵⁰ In those instances, the idea of permission is irrelevant, but there still must be payment in order to assure the party responsible for the externality internalizes the cost of his activity. When transaction costs are low, there is no good reason to allow one party to take the property of another without permission.¹⁵¹ They can negotiate, and as will be discussed later,¹⁵² there is no reason to expect the injured party to be undercompensated.

In the auto case, suppose one hour after delivering the car, Felix calls Jane with the offer of \$8,000. What should she do? She could attempt to buy the car back from Todd, or if she kept a spare set of keys, she could take the car and leave Todd \$6,500. Do we want her to do this?¹⁵³ Maybe so. After all, under the efficient breach theory, there is little to distinguish “theft with payment” from “breach with payment.”¹⁵⁴ In each case, there is an absence of consent. And each option avoids the transaction costs of a renegotiation, during which Todd might ask inconvenient questions like, “Why do you want the car back?” Nevertheless, the only thing Jane can lawfully do is similar to specific performance. Jane must negotiate in order to “undo” the contract.

Now move the timing back a little, and she is approaching Todd’s house where she is to deliver the car. Just before arriving, she receives the call from Felix. Now a liability rule is likely to apply, and Jane can give Todd the check and resell to Felix. In effect, the transaction costs of non-performance depends on a contrived notion of when Todd comes to “own” the car. The problem, according to Professor Macneil, is that the idea of how to define when something is officially someone’s property does not have an economic rationale but actually leads to remedies about which vari-

150. See Farber, *supra* note 1, at 1444. The transaction cost analysis would tend to favor a property rule or specific performance in contracts cases. See Kronman, *supra* note 13, at 363-64.

151. Actually one justification is the avoidance of bilateral monopoly. Bilateral monopoly exists when there is one seller for which there are no good substitutes (a monopoly) and a single potential buyer (monopsony). Since neither party has an option and each knows that, there may be a risk of an impasse and no sale. This can be regarded as a type of transaction cost. See Calabresi & Melamed, *supra* note 148.

152. See *infra* Section III.C.

153. This would involve shifting a property rule to a liability rule and is one explanation for criminal law. Calabresi & Melamed, *supra* note 148, at 1126. The difference is that the liability rule requires no consent, but the property rule does. *Id.* at 1126-27. This seems to beg the issue of why it is necessary to have a property rule if compensation takes place. One answer, as suggested in the text, is that property rules are superior at ensuring the “injured” party is not made worse off. *Id.* at 1125-26.

154. See *id.* at 1124-27.

ous economic rationales are applied.¹⁵⁵ After all, ownership could be defined as attaching anytime from when the contract is signed to after Todd has put 1,000 miles on the odometer. This may seem fanciful, but it is actually consistent with things such as “cooling-off” periods¹⁵⁶ as well as sections of the Uniform Commercial Code¹⁵⁷ and the Restatement (Second) of Contracts,¹⁵⁸ which actually define when, in effect, a buyer acquires a property right.

One does not have the impression that Professor Macneil would have embraced the concept of the efficient breach even if these hurdles could be addressed. On the other hand, implicit in his analysis is the moral acceptance of an efficiency standard in contracts. Moreover, his claim that the efficient breach is a fallacy is a bit overstated. Or, more specifically, it does not necessarily follow from his criticism. Indeed, it may be unfair to law and economics scholars to view them as wedded to one remedy or another. They have disagreed over the means to the end of the efficient breach, but they seem united in viewing the efficient breach as a goal. Nevertheless, Professor Macneil pointed out for the first time that the superiority of expectancy over specific performance was far from a forgone conclusion and that the superiority of one rule over another was a function of context.¹⁵⁹

B. In Favor of Specific Performance

The debate about expectancy and specific performance has taken a number of forms. Anthony Kronman appears to be the first to have noted that low transaction costs in the contracts setting would tend to favor reliance on specific performance.¹⁶⁰ His preference for specific performance has been echoed by a number of writers, perhaps most notably Alan Schwartz.¹⁶¹ In his 1979 effort in favor of specific performance, Schwartz cited the superiority of specific performance in terms of achieving the compensation goal.¹⁶² He also argued against the rationales presented in favor of

155. Macneil, *supra* note 11, at 963-65.

156. See E. ALLAN FARNSWORTH, CHANGING YOUR MIND: THE LAW OF REGRETTED DECISIONS 24 (1998). Possibly the best known “cooling-off” period” is that applied by the Federal Trade Commission to door-to-door sales. See 16 C.F.R. § 429.1(a) (2012). It allows consumers to change their minds within three days. *Id.*

157. See U.C.C. § 2-503 (2012).

158. See generally Ian R. Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589 (1974).

159. Macneil, *supra* note 11, at 957.

160. Kronman, *supra* note 13, at 368.

161. See generally Schwartz, *supra* note 16.

162. *Id.* at 274. It is not clear that Schwartz is equating the compensation goal with the goal of internalizing at efficient levels. It is possible to achieve the first outcome without the second.

damages over specific performance.¹⁶³ In 1990, he returned indirectly to the topic by noting the similarity of specific performance to penalty clauses and making the point that whatever preference parties have for specific performance is not based on the desire for supracompensatory damages.¹⁶⁴ In the case law, perhaps the most well-known economic support for specific performance is found in Judge Posner's opinion in *Walgreen Co. v. Sara Creek Property Co.*¹⁶⁵ In that case, Walgreen, a shopping center tenant, sued Sara Creek for violating a condition in its lease that guaranteed there would be no other drug stores in the center.¹⁶⁶ In his opinion favoring the grant of a permanent injunction, Posner noted two advantages of the injunction over an award of damages:

First, it shifts the burden of determining the cost of the defendant's conduct from the court to the parties. If it is true that Walgreen's damages are smaller than the gain to Sara Creek from allowing a second pharmacy into the shopping mall, then there must be a price for dissolving the injunction that will make both parties better off. Thus, the effect of upholding the injunction would be to substitute for the costly processes of forensic fact determination the less costly processes of private negotiation. Second, a premise of our free-market system, and the lesson of experience here and abroad as well, is that prices and costs are more accurately determined by the market than by government. A battle of experts is a less reliable method of determining the actual cost to Walgreen of facing new competition than negotiations between Walgreen and Sara Creek over the price at which Walgreen would feel adequately compensated for having to face that competition.¹⁶⁷

In this passage, Posner concedes that expectancy damages may or may not result in the proper level of internalization.¹⁶⁸ He also notes that the price paid by Sara Creek will be determined by the parties, and thus, compensation of the non-breaching party is assured.¹⁶⁹

The process and the superiority of specific performance in this regard can be understood by reference again to the contract curve.¹⁷⁰ Now the contract curve extends from the lowest amount that Walgreen will accept to release Sara Creek from its obligation to the most Sara Creek will pay for that right. The most Sara Creek will pay is the profit¹⁷¹ to be made by leasing to a competitor of Walgreen. The least Walgreen will take is the profit it

163. See generally *id.*

164. Alan Schwartz, *The Myth That Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 370 (1990).

165. 966 F.2d 273 (7th Cir. 1992).

166. *Id.* at 274.

167. *Id.* at 275-76.

168. See *id.*

169. See *id.*

170. See *supra* text accompanying notes 73-75.

171. Sara Creek may also deduct from this any harm to its reputation or other costs of having appeared to breach, but most of these would have been sunk costs in the time frame of the case.

estimates it will lose if the competitor is present. The profit lost by Walgreen is the actual harm caused and should be internalized. There is no reason to think this would be acceptable to Walgreen given it now possesses the right to force performance. In fact, it is now a monopoly seller of the right of Sara Creek to lease to a competitor. Efficient non-performance will not occur unless Walgreen is fully compensated and Sara Creek internalizes the harm. On the other hand, as will be seen, non-performance may also occur if internalization is supracompensatory, and if so, specific performance will fail to carry through on its promise of efficiency.

Another point made by those favoring specific performance is that there is evidence that contracting parties actually prefer specific performance.¹⁷² This is difficult to determine because in many instances that preference may not be obvious due to the fact that courts are unwilling to grant specific performance, and the litigants know it.¹⁷³ Nevertheless, Steven Shavell has argued that at least some evidence exists that specific performance is the preferred remedy.¹⁷⁴ More importantly, a series of empirical studies reported on and conducted by Tess Wilkinson-Ryan and David Hoffman provide additional support for a preference for specific performance.¹⁷⁵ This is not surprising. Routine availability of specific performance means the worst-case scenario for the non-breaching party will be full compensation while, in the case of expectancy, it is merely a possibility. There is some danger of making too much of these studies due to methodological limitations. For the most part, the studies suggest to the subject that he or she is in the role of the non-breaching party after the hypothetical breach occurs.¹⁷⁶ They do not seem to ask what the preferred remedy would be if the subject of the survey were the breaching party. In effect, subjects likely are affected by something akin to the endowment effect in that they are conscious of their own position. A better measure could be to pose the same questions to subjects who are behind a version of the "veil of ignorance."¹⁷⁷

Putting these possible problems aside, the theory for why there is a preference for specific performance makes sense. According to Wilkinson-Ryan & Hoffman damages do not adequately address the "psychology of . . . breach."¹⁷⁸ This factor is distinguishable from the fact that expectancy damages do not protect the subjective and monetized valuations placed on

172. See, e.g., Steven Shavell, *Specific Performance Versus Damages for Breach of Contract: An Economic Analysis*, 84 TEX. L. REV. 831, 875-76 (2006).

173. See *id.* at 875.

174. *Id.* at 875-76.

175. See generally Wilkinson-Ryan & Hoffman, *supra* note 17.

176. *Id.* at 1014, 1025.

177. The veil of ignorance, as those familiar with the writings of John Rawls will recognize, prevents the parties from knowing how a rule will affect them personally. See JOHN RAWLS, *A THEORY OF JUSTICE* 118-23 (rev. ed. 1999).

178. Wilkinson-Ryan & Hoffman, *supra* note 17, at 1014.

performance by non-breaching parties. Instead, these studies indicate that there is a sense of injury by virtue of the broken promise.¹⁷⁹ For example, in one instance non-breaching parties reported, on average, that payment of 2.19 times expectancy should be paid, and if faced with a choice, they preferred specific performance by a large margin.¹⁸⁰ Breach for the most part was regarded as immoral.¹⁸¹ Blended in with these emotions appears to be a sense of having been exploited when a contract is breached.¹⁸²

Precisely what is going on in these instances and the reaction, if any, by contract law, is difficult to determine with certainty. It goes without saying that the negative reaction to damages as opposed to specific performance is a function of expectations or a sense of entitlement to performance.¹⁸³ Suppose the same subjects had taken a course on how the system actually works and knew that expectancy is the norm. There is some possibility, at least, that their sense of injustice would soften. In short, the problem may lie less in contract law than it does in the misinformation provided by a superficial understanding of the law.¹⁸⁴

In addition, some of the objections to damages seem to be fueled by the sense of not having been treated fairly.¹⁸⁵ In those instances, higher damage awards may well solve the problem.¹⁸⁶ In these cases, it becomes difficult to separate undercompensation from a more deontological-based sense of wrong.¹⁸⁷ In fact, the latter possibility is supported by the desire of non-breaching parties to punish those who have breached even when there is no personal gain.¹⁸⁸ There are two important implications of these studies. One is that they seem to support specific performance.¹⁸⁹ Second, any modern discussions of compensatory and expectancy damages that do not account for those phenomena are incomplete.

A final argument in favor of specific performance is largely non-economic in any technical sense. Returning to Sara Creek and Walgreen, think again about the contract curve and suppose Walgreen's loss from the presence of a competitor is \$10,000 and Sara Creek's gain is \$20,000. In the world of efficient breach, Walgreen would receive \$10,000 and be indiffer-

179. *See id.*

180. *Id.*

181. *See id.* Again, the juxtaposition of moral decision with payments that will restore a sense of morality is problematic. *See supra* Section II.D.

182. Wilkinson-Ryan & Hoffman, *supra* note 17, at 1017.

183. Harrison, *supra* note 79, at 446.

184. *See* Wilkinson-Ryan & Hoffman, *supra* note 17, at 1015.

185. *Id.* at 1028-31. Of course, there are many determinants of the development of a sense of unfairness. *See generally* Harrison, *supra* note 79.

186. Wilkinson-Ryan & Hoffman, *supra* note 17, at 1025-27.

187. *See id.* at 1014, 1016.

188. *Id.* at 1034.

189. *Id.* at 1014.

ent to receiving a check or being the sole drugstore in the shopping center. Specific performance means that Sara Creek will be required to share part of the gain created by the breach. This idea of sharing has appeal, and it seems likely that it is fueled by the sense that Walgreen was a victim and Sarah Creek was the more powerful party. Even if this were the case, most economists, in their role as economists, would say they cannot support the redistribution argument because it involves an interpersonal comparison of utility. That is probably true, but there may be a better reason for not automatically favoring sharing. The instinct to favor sharing assumes the breaching party is almost invariably the weaker and poorer party. There appears to be no basis for this supposition. Indeed, how many would favor the sharing solution if the breaching party were Bill Gates' gardener? For example, let's say the gardener is paid \$100 to mow the Gates' yard. Another customer then offers the gardener \$200. Are we inclined to order specific performance to ensure that Gates gets part of the profit from the breach? Probably not. In reality, we cannot know when the distributive effects of specific performance will be pleasing to our sense of justice.

C. The Failure of Specific Performance

In order to understand the ultimate failure of specific performance, it is useful to return to the modified version of the *Peevyhouse* case.¹⁹⁰ A close look reveals the efficiency of specific performance, on the one hand, and the source of an almost assured inefficiency on the other. Garland Coal purchased the rights to strip mine land owned by the Peevyhouses.¹⁹¹ Part of the consideration was to restore the land to its original condition. Garland Coal breached this part of the contract, and the Peevyhouses sued for damages.¹⁹² Actually performing the restoration would cost \$29,000.¹⁹³ Aside from showing that expectancy can be measured in more than one way,¹⁹⁴ the case seems to illustrate a situation in which specific performance is the appropriate remedy if the goal is for Garland Coal to internalize the harm to the Peevyhouses of the breach. In Judge Posner's *Sara Creek* language, "prices and costs are more accurately determined by the market than by government."¹⁹⁵ If Judge Posner means that parties, aided by the market, can more efficiently determine a price, he is correct. If he is suggesting that the par-

190. See *supra* text accompanying notes 39-46.

191. *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109, 111 (Okla. 1963).

192. *Id.* In the case, as opposed to the modified version presented here, actual damages were calculated at \$300. *Id.* at 114.

193. *Id.* at 111.

194. The case is typically used to illustrate the question of whether cost of performance or diminution of value should be awarded. *Id.*

195. See *Walgreen Co. v. Sara Creek Prop. Co.*, 966 F.2d 273, 276 (7th Cir. 1992); see also *supra* text accompanying note 167.

ties in a bilateral monopoly are comparable to a "market," he is obviously incorrect. More specifically, it is incorrect if he is suggesting the price determined is a measure of the harm caused.

One can understand this by considering the Peevyhouses after they have been granted specific performance. Someone from Garland Coal calls to inquire about how much it will cost to buy the right not to restore the land. Any price lower than \$29,000 would make Garland Coal better off. The Peevyhouses may very well stick to a price in excess of that amount. If so, Garland Coal will restore the land, and the outcome will be efficient. In fact, insistence on restoration indicates the breach was not efficient since the harm to the Peevyhouses exceeds the gain to Garland Coal of not performing.

On the other hand, the Peevyhouses may be willing to take an amount less than \$29,000 because they are actually indifferent between having the land restored and receiving \$15,000. In this case, the breach is efficient and the amount to be internalized by Garland Coal would be \$15,000. But why settle for \$15,000? It is the lowest point on the contract curve, and now the Peevyhouses have monopoly power. Why would they follow a rule any different from that followed by any monopolist and not charge what the market will bear? The only leverage Garland Coal has is it can threaten to restore the land. And, oddly, this is the same leverage the Peevyhouses have—it can force Garland Coal to restore the land. We have a contract curve ranging from \$15,000 to \$29,000. Any amount between those extremes means both parties are better off if the land is not restored. Unless bilateral monopoly problems get in the way, Garland Coal will buy the right for an amount between \$15,000 and \$29,000. This will be efficient in the sense that the resources that would have been used to restore the land will be redirected to some other uses. Moreover, the outcome is attractive to many because it protects the Peevyhouses from a monetary award that would not have been compensatory and would have meant a gross under internalization by the Peevyhouses. In effect, specific performance ensures that the breach does not occur unless it is efficient. A slightly more technical way to state this is that under specific performance, the non-breaching party will have a reservation price (the least it will take) that is no less than the actual harm suffered.¹⁹⁶

This appears to be a good outcome all around. There are, however, two problems. One could be viewed as relatively minor and the other perhaps pervasive. If a jurisdiction adopts specific performance as a default rule, there will almost certainly be negotiation about the price to the breach-

196. Judge Posner has noted the attractiveness of specific performance because it shifts the task of determining damages from the court to the parties. *Sara Creek*, 966 F.2d at 275. Whether this actually lowers the costs of the determination is a different question.

ing party of avoiding performance.¹⁹⁷ In the example here, the parties will have to select a price between \$15,000 and \$29,000, which means there will be transaction costs. As transaction costs increase, the probability that Garland Coal will actually buy the right to take the efficient course and not perform declines. In short, specific performance will protect the Peevyhouses from an inefficient breach, but high transaction costs may prevent efficient non-performance from occurring. This basic theory applies, perhaps to a lesser extent, to liquidated damages and punitive damages as well. For example, suppose the Peevyhouses had a punitive damages clause that called for a \$50,000 payment if the land was not restored. If the Peevyhouses insist on the \$29,000, Garland Coal's leverage is to restore the land, which, as in the hypothetical, is only worth \$15,000 to the Peevyhouses. At any price above \$15,000 they would be better off, and if they understand the situation, they will negotiate and ultimately agree to sell their right to liquidated damages for something between \$15,000 and \$29,000. In this case, liquidated damages would not prevent efficient non-performance but would make it more expensive to achieve.¹⁹⁸

Arguments that punitive damages for breach of contract would impede efficient non-performance follow this pattern. For example, consider again the Peevyhouses, and suppose Oklahoma, the state in which the case arose, had a law that said, "Any party breaching a contract with respect to the restoration of land will be liable for damages plus \$100,000." Now Garland Coal once again decides it would prefer not to restore the land. The Peevyhouses know about the \$100,000 and may feel they have Garland Coal in a bind. Garland Coal's way out of the bind is to pay the Peevyhouses. Again, they are willing to pay up to \$29,000 because if the Peevyhouses demand more, Garland Coal will restore the land. And again, the Peevyhouses are better off with anything over \$15,000. The same negotiation between \$15,000 and \$29,000 will occur.¹⁹⁹ In effect, any remedy that forces Garland Coal to bargain with the non-breaching party may result in higher transaction costs, but it also means increasing, over expectancy, the probability that, when non-performance does take place, it will be consistent with an efficient redirection of resources.²⁰⁰

In sum, at least to this point, assuming the law is clear, expectancy probably means lower transaction costs but a lower probability of the proper

197. If there is uncertainty and the remedy is damages, the post-decision transaction costs are lower than if specific performance is granted.

198. Interestingly, the similarity of liquidated damages to specific performance was missed by some of those first writing about the topic including, it appears, both Professor Linzer and Judge Posner. See Linzer, *supra* note 11, at 115; *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir. 1985).

199. Regardless of the rule applied, Garland has a buyout point of \$29,000.

200. This analysis changes when the costs of Garland Coal unexpectedly increase. See *infra* notes 204-05 and accompanying text; see also *supra* Section III.C.

level of internalization. This means a higher risk of false positives. Specific performance is likely to be more expensive transaction cost-wise but, unless these costs are excessive, it is more likely to result in efficient non-performance. When transactions costs are high there is a danger of false negatives. Unfortunately, it is not that simple, and the second problem is a more serious one.

D. False Positives, False Negatives, and Downstream Effects

The possibility of false positives, false negatives, and downstream effects of expectancy were noted above.²⁰¹ The same analysis can be applied to specific performance but with outcomes that are more predictable. Yet again return to the *Peevyhouse* case but suppose the jurisdiction is one that will order specific performance or one of the surrogates—liquidated damages or punitive damages. As noted above, the contract curve will extend from \$15,000, the least the Peevyhouses will accept, to \$29,000, the most Garland Coal will agree to pay. The least the Peevyhouses would take is the amount that would leave them indifferent between the payment and the restoration of the land. It fully includes any subjective valuation and even “moral” judgments they may have about breach. The problem is that this fully compensatory amount is just the starting point for the negotiation.²⁰² In the case of the sale of an already existing car by a non-producer—the Honda hypothetical above—this may be no more than a distributive matter.²⁰³

On the other hand, something more than a distributive issue arises when, as in the *Peevyhouse* case, the party internalizing the harm is an ongoing business. Given that they hold the trump card for requiring Garland Coal to spend \$29,000, the Peevyhouses need not accept their indifference amount. So, let’s suppose they bargain to a settlement of \$20,000. This is \$5,000 in excess of any possible measure of actual harm. More importantly, we have an ongoing business—Garland Coal—internalizing a cost in an amount that is in excess of the amount that would fully compensate the “seller” for the right not to perform. The downstream market is affected in the same way as overcompensation in the context of damages.

The downstream impact of specific performance becomes more pronounced if the numbers are altered a bit. Suppose the Peevyhouses and Garland Coal are generally in agreement that specific performance will be the

201. See *supra* Section II.F.

202. This too may be of little consequence in cases in which the breaching party is viewed as simply being required to share part of the profit from the breach with the non-breaching party. The usual argument here is that it is merely a distributive issue and economics is unable to evaluate the social welfare effects.

203. Steven Shavell has also distinguished between goods that exist and those to be produced in order to make a somewhat different point. See Shavell, *supra* note 172, at 875-76.

default remedy. Suppose, however, that it turns out that the restoration would cost \$70,000, not the \$29,000 that was expected. At that price, Garland Coal will have an incentive to breach. Now, however, the leverage of performing at \$29,000 is lost. The contract curve now stretches from \$15,000 to \$70,000. Whatever the settlement price, it will be in excess of the actual harm and the predictable downstream effect may occur.

A default rule of specific performance creates a powerful risk of over-internalization. Is there a way to control this persistent over-internalization? One way is to leave it unclear when specific performance will be required. This means if the Peevyhouses turn out to be hard bargainers, there will be litigation with the outcome that they will end up with \$300, the decrease in the value of the land. On the other hand, the analysis above illustrates that moving back to damages just means incurring the risks of under- or over-compensation as well as false positives.

Another possibility is to couple a policy of routine specific performance with a relatively liberal approach to excuse for non-performance. It is possible that the threat of a court actually excusing the performance of Garland Coal does increase the leverage of Garland Coal in bargaining with the Peevyhouses. In fact, a case can be made that any pronounced shift to specific performance as a default rule should be accompanied by a relatively liberal approach to various excuses for non-performance.

Note that specific performance will not create a risk of false positives. Since the non-breaching party is in control of whether non-performance will be permitted, they will almost certainly avoid this problem. False negatives are possible, however, when the non-breaching party attempts to exploit its position. For example, in the original example, the value of performance to the Peevyhouses is \$15,000, but the contract curve extends all the way to \$29,000. This may encourage the Peevyhouses to stick to a price in excess of \$29,000 with the result being that the land is restored. This is a false negative. This sort of impasse is viewed as a risk of bilateral monopoly, although the incidence of impasse is not clear given that both parties are worse off.

If there are no false positives and limited false negatives, can one say specific performance encourages efficient non-performance? The answer is yes, but this is a very shallow notion of efficiency. The parties to the contract are better off if the outcome is non-performance. The price charged by the non-breaching party for the right not to perform will reflect the market power of the selling party and will be in excess of a compensatory amount. This in turn is passed down to buyers in the market in which the non-performing party operates. As noted above, these passed-on costs in excess of actual harm promote inefficiencies in the downstream market by over-

stating actual costs of production.²⁰⁴ Consequently, adherence to a rule that seems to increase the likelihood of an efficient outcome between the parties actually sets into motion the source of another inefficiency.

Although the final outcome is an empirical question, the two remedies can be compared. As a general matter, expectancy is more likely to result in false positives as far as identifying efficient breaches, and this translates to inefficiently low prices and high levels of output in downstream markets. One might argue the chances of false positives and false negatives are random and there is no reason to believe one would occur more than the other. This seems unlikely, but even if it were the case, there is no offsetting impact in downstream markets because it is unlikely if not impossible that the same firm will be affected by offsetting levels of over- and under-compensation. On the other hand, due to transaction costs, including those created by bilateral monopoly, specific performance may lead to false negatives. More importantly, even when there is no false negative and the breach (non-performance) occurs, a consistent consequence would be the internalizing of costs in excess of harm with the result being reflected in artificially high costs in the output market.²⁰⁵

IV. A NEW DEFENSE OF EXPECTANCY: AN INCOMPLETE ARGUMENT

The argument thus far is that comparisons of expectancy and specific performance, as far as efficiency is concerned, make for a moderately interesting academic discussion but are of little use. Recently, however, two Yale professors published in the *Virginia Law Review* in an effort to revive

204. See discussion *supra* Section III.C.

205. It may appear that a solution to uncertainty and transaction costs would be for the parties to consistently insert a liquidated damages clause in their contracts that reflects a prenegotiated "buy out" price. For example, suppose a jurisdiction required the inclusion of liquidated damages clauses. In the *Peevyhouse* case, suppose the contract required restoration of the land but included a clause indicating that, if the land were not restored, Garland Coal would pay the Peevyhouses \$15,000—the compensatory amount. The idea would be to set the price for an efficient breach ahead of time and before a bilateral monopoly is created. On balance, this is not a very practical solution. First, an allowance for liquidated damages is itself just a contract term. Required inclusion raises transaction costs of the initial contract. In effect, a new type of false negative comes into play in the sense that otherwise efficiency-producing contracts would not be formed due to the increased transaction costs of negotiating the original contract. Second, if actual damages turned out to be substantially lower, one side would almost certainly claim it was a penalty. If damages were substantially higher, the figure would lead to the risk of false positives. Third, even though liquidated damages clauses ideally are set at amounts equal to "anticipated or actual harm," in fact, they perform other functions that may cause them to deviate from expected harm. See POSNER, 7th edition, *supra* note 8, at 127-29. Finally, as a negotiated term of the contract, parties would likely agree to different amounts for the very same harm depending on concessions made with respect to other terms of the contract.

expectancy.²⁰⁶ Markovits and Schwartz, in nearly impenetrable language rendering it likely to be of interest to a narrower than usual population of law professors, largely reframe arguments made in the past. In the process, for an unexplained reason, they ignore thirty years of research on rationality and decision-making, seem to become unglued from the original question of how to assure the efficient breach, and rely on justifications that should be discarded.²⁰⁷

The Markovits and Schwartz purport to present an argument against what they view as the conventional view that “[a] promisee . . . 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.”²⁰⁸ The authors respond to this argument with one that says, in effect, that a contracting party would not *care* whether there is performance or payment.²⁰⁹ Their argument is that there really is no difference in outcome to non-breaching parties under specific performance (a property rule) and expectancy (a liability rule).²¹⁰ Put simply, suppose there is specific performance, and the promisor has a better opportunity. The non-breaching party will bargain to allow the promisor out of the contract. He will receive an amount equal to expectancy and a share of the profit associated with the breach. The authors refer to this as a bribe.²¹¹ But, according to the parties, the potential to receive a bribe only comes at a cost.²¹² The party who pays the bribe in order to escape the obligation to perform will raise the contract price.²¹³ On the other hand, if the only remedy is expectancy, the price in the original contract will be lowered by the amount of the bribe.²¹⁴ Put differently, the party will charge less because it will be able to keep all the benefits of a breach once damages are paid.²¹⁵ They note that a rule allowing payment of damages would likely be

206. Markovits & Schwartz, *supra* note 1.

207. *Id.* The authors begin with a summary of the criticisms of expectancy. *Id.* at 1940-47. Among those is that a promisee who knows he or she may only receive the monetary equivalent of performance will be reluctant to invest in the contract. The authors offer no support for the idea that expectancy results in underinvestment. Moreover, if expectancy is properly calculated, any lost investment would be fully compensated.

208. *Id.* at 1950.

209. *Id.* at 1950-51.

210. *Id.* at 1951.

211. *Id.* at 1950-51.

212. *Id.*

213. *Id.*

214. *Id.* at 1951. The authors note evidence from experiments suggesting that there is a preference for specific performance and correctly note the flaws in those efforts. *Id.* at 1954 n.32.

215. This particular proposition was made by Richard Craswell over twenty years ago. See Craswell, *supra* note 30, at 642.

selected mainly because it lowers transaction costs and increases the net benefit associated with breach.²¹⁶

In fairness, Markovits and Schwartz concede that they must make a series of assumptions to reach this outcome.²¹⁷ As is often the case, the assumptions remove virtually all of the factors that explain the outcome of actual contractual relationships.²¹⁸ Moreover, it is not clear what is added to the efficient breach analysis.²¹⁹ Having made the claim that expectancy and specific performance in a rational world of complete and evidently inexpensive information in which sophisticated parties bargain are the same,²²⁰ there does not seem to be an effort to square either remedy with efficiency. As a consequence, the argument can be reduced to, as far as efficiency, one remedy is not worse than another, but neither may have very much to do with the efficient breach.

In order to understand this last point, it is useful to break down the idea a bit more. In the case of specific performance or a property rule, the promisee pays a higher price in order to receive, should there be a breach, the compensatory amount plus a share of the gain.²²¹ And, if only damages are permitted, the promisee pays a lower price with the understanding that he will receive compensation, but no more.²²² In both cases, part of the award is expectancy. In effect, Markovits and Schwartz respond to critics of expectancy by basing their argument on the foundation of expectancy.²²³ Moreover, whether discussing specific performance or damages, they appear to ignore the issue of whether either one involves the correct level of internalization by the breaching party.²²⁴ In this respect, Markovits and Schwartz enter the world that reminds one of Monroe Freedman's skyhooks and the relative advantages of one "hook" over the other.²²⁵ That discussion would be useful if there were skyhooks and the Markovits and Schwartz discussion would be of interest and useful if there were any remedy that could achieve the efficient breach.

Two elements of their defense are particularly worth noting. Both are related to their view that the parties, under their set of conditions, would

216. Markovits & Schwartz, *supra* note 1, at 1945.

217. *Id.*

218. The authors indicate that the assumption basically tracks those made by people who are critical of expectancy. *See id.* There appears to be no support for this assertion.

219. The authors argue that the efficient breach is a myth. *Id.* at 1948-49. Their reasoning is that a breach only occurs when a party neither performs nor pays damages. *Id.* at 1948.

220. *Id.* at 1987.

221. *See id.* at 1941, 1950-51.

222. *See id.*

223. *Id.* at 1942.

224. *See generally id.* In this respect, they seem to have lost sight of why economic analysis has been brought to bear on the subject of breach of contract in the first place.

225. *See supra* notes 25-27 and accompanying text.

choose expectancy. First, they may have implicitly revived an old, and in this case, flawed idea.²²⁶ The core of their proof is that whether one bargains only for expectancy or an absolute right to performance will be reflected in the price paid and that, except for transaction costs, the two are equivalent.²²⁷ Since expectancy is the less expensive route or the one that would result in the largest net profit, it is the one to which the parties would agree.²²⁸ Thus, expectancy should be the default remedy.²²⁹

Here things become cloudy, and the reader should consult the original text.²³⁰ The problem is that the notion of *default* is not clear. Typically, default rules apply when the parties have not expressly agreed to a specific term. Of course, there are instances in which agreement to a default term may be inferred. It may be that their point is that parties would generally agree to expectancy if they had thought about it. But if this is the point, the authors could have confirmed their hypothesis with a relatively simple survey. In short, it would have been an easy matter to test their theory.

Still the question remains, can we assume if the parties had thought about it, they would have consented to expectancy? If so, two things would have to occur to make that appropriate. Without knowing it, the non-breaching party must be “paid” in advance by virtue of a lower price for giving up the right to share in the profit associated with the breach. Second, because of that payment, the parties must be regarded as having consented in one way or another to the transaction that is unknown to him.

Suppose the first condition is met and the price is lower. This raises the issue of whether, having been paid for the risk of a breach, one has “consented” to the consequences of the breach including being held to an expectancy remedy. In the early 1980s, Richard Posner made this claim as a way to suggest that Kaldor-Hicks efficiency is morally defensible.²³¹ The relevant term was “*ex ante* compensation.”²³² In effect, if a party were subjected to a loss in furtherance of a Kaldor-Hicks efficient outcome, their consent could somehow be justified by *ex ante* compensation. For example, suppose a new neighbor begins raising pigs on property next to yours. The odor is awful, but it does turn out that the profit from hog raising is greater than the decline in the value of your property, and thus, hog farming is Kal-

226. See Markovits & Schwartz, *supra* note 1, at 1948.

227. *Id.* at 1950-51.

228. *Id.* at 1951-52. See discussion *supra* at notes 156-59.

229. *Id.* at 1952 n.29.

230. This part of the presentation is somewhat confusing in that the authors' summation is that they have defended the expectancy or the liability rule “on five related grounds.” *Id.* at 2006. Is it not clear whether the grounds are necessary or sufficient. For example, one ground is that “the liability rule contract would be a good default.” *Id.* Another ground is that “[a] promisee's consent to a liability rule default is actual rather than hypothetical.” *Id.*

231. See POSNER, *supra* note 68, at 95.

232. *Id.* at 94.

dor-Hicks efficient. In the world of “*ex ante* compensation,” you should have no complaints because the price you paid for your property was lower because you did not buy a right to a “pig free” environment.²³³

The notion of *ex ante* compensation as a form of consent has been discredited.²³⁴ The problem is that the Markovits and Schwartz position with respect to expectancy as a default rule seems to raise the specter of *ex ante* compensation arguments again. If it does not, the implications of their hypothesis are very narrow and could be tested. If it does, the analysis fails completely as far as any practical implications. Yet there appears nothing in this model to suggest that those without a right to specific performance actually do pay less. Moreover, if it could be shown that those without a right to specific performance pay less, there is no sensible connection between the “discounted” payment as “consent.”

Second, underlying the analysis seems to be the idea that parties would consent—*actually* consent—to expectancy damages because transaction costs would be lower. In other words, the net surplus created by a liability rule would be higher than under a property rule, and therefore, a liability rule would be preferable to the parties. They would agree not to require specific performance. Here, again, the logic is not obvious. To understand why, think about the Peevyhouses, and assume at the outset that Garland Coal and the Peevyhouses can select an expectancy remedy or specific performance. They both understand that if specific performance is selected, the Peevyhouses will pay more, and for that extra payment, they will buy a share in any profit Garland Coal makes by not performing. The Peevyhouses also understand that paying more for specific performance will mean the profit (from the breach) to be split between the parties will be lower due to transaction costs. On the other hand, they also know that, even though under expectancy the profit will be larger, they will receive no share.

In simple numerical form, suppose the profit from an expected breach is \$10,000.²³⁵ This is reduced to \$9,500 if the transaction costs associated with negotiation are subtracted. Now the Peevyhouses must decide whether they prefer to pay to receive their full damages plus a share of the \$9,500 profit or pay less and receive nothing of the \$10,000. What is missing here is any recognition of what is clear from studies of behavioral economics. Parties are quite willing to opt for something other than the maximum total payout if they do not feel they are receiving a fair share of the payout. The

233. Interestingly, under a view of *ex ante* compensation as comparable to consent, the only way one could avoid consenting would be to refuse the compensation that one is likely to be unaware of in the first place.

234. Coleman, *supra* note 68, at 534-39.

235. To be accurate this must be expressed as “expected” profit because one part of the calculation is the probability that a breach will occur.

theory that one party would consistently agree to maximize joint profit—in this case, choose the expectancy option—is simply not supportable.

CONCLUSION

When everything that can be said has been said, one may ask what one more article on the topic of “efficient breach” can add. The purpose of this Article is to demonstrate that there is no practical conception of the efficient breach. This Article focuses on the importance of internalization as the goal of efficient breach. The Kaldor-Hicks notion of efficiency may be the best place to start²³⁶ with respect to the assessment of expectancy, but it is ultimately a deeply flawed concept of efficiency. Among other things, the complexity and fluidity of the ideas of rationality and welfare make the connection between efficiency and expectancy random for practical purposes. Specific performance does overcome some of the problems of expectancy by eliminating the false positive problem. On the other hand, it is an odd proposition that the way to achieve efficiency is by granting one party to a contract monopoly power—the antithesis of efficiency. Indeed, the downstream impact of specific performance just means that one economic evil is replaced by another. The efficient breach is no more than an “idea.”

Perhaps the good news is that, while scholars have been filling law review pages with discussion of the efficient breach, courts have not been particularly interested in or persuaded by what they have written.²³⁷ There is evidence that specific performance is more generally available than it was decades ago.²³⁸ It is quite another matter to attribute this to economic arguments found in legal scholarship. Although one cannot determine the impact of legal scholarship with confidence, citation rates for scholarly articles that one might have expected to be influential have been quite low.²³⁹ Plus, the

236. See *supra* Section II.A. This is because the Kaldor-Hicks standard would be the easiest to satisfy. There can be no interpersonal comparison of utility as required under utilitarianism. Under a Pareto standard, no breach without permission would be acceptable.

237. As already noted, the term “efficient breach” is found a mere 140 times in a search using the Westlaw database “ALLCASES.” See *supra* note 4.

238. Jeffrey L. Harrison, *Trends and Traces: A Preliminary Evaluation of Economic Analysis in Contract Law*, 1988 ANN. SURV. AM. L. 73, 98. See generally Jeffrey L. Harrison, *The Influence of Law and Economics Scholarship on Contract Law: Impressions Twenty-Five Years Later*, 68 N.Y.U. ANN. SURV. AM. L. 1 (2012).

239. For example, Alan Schwartz’s seminal article on specific performance, *supra* note 16, has been cited a total of twenty-five times since it was published in 1979. In no cases does it appear that his work influenced the decision. This search was conducted using the Westlaw database “ALLCASES.” Similarly, Anthony Kronman’s article on specific performance has been cited but six times. Kronman, *supra* note 13. There are, of course, a multitude of ways scholarship may influence the direction of the law without resulting in judicial citation, but at least based on this sliver of evidence, as it relates to two well-known scholars, one could not conclude that courts are responsive to scholarly arguments in favor of

more liberal attitude toward specific performance found in the UCC²⁴⁰ and the Restatement (Second) of Contracts,²⁴¹ predated almost all economic arguments. Whatever trend there may or may not be in favor of specific performance, this Article demonstrates that it is not consistent with greater economic efficiency. Arguments that specific performance is more efficient apply a very myopic concept of efficiency.

Interestingly, adherence to expectancy is also difficult to square with economic arguments. The application of expectancy means adhering to the status quo, which existed well before economic arguments emerged. Even if there were a link between economic analysis, expectancy, and the efficient breach, it would be inappropriate. There are simply too many variables involved to confidently link to efficient breach. Despite all of this, legal scholars continue to debate the issue. Indeed the debate now may have come full circle as old and obsolete ideas are recycled. It may be appropriate to continue the discussion of skyhooks, but in the interest of linking legal scholarship to law, even broadly defined, perhaps the discussion should only continue when there is something new and useful to say.

specific performance. Indeed Professor Macneil's early and thoughtful rejection of the notion of efficiency breach has been cited only twice in forty years. Macneil, *supra* note 11.

240. See *E. Air Lines, Inc. v. Gulf Oil Corp.*, 415 F. Supp. 429, 442 (S.D. Fla. 1975); *Kaiser Trading Co. v. Associated Metals & Minerals Corp.*, 321 F. Supp. 923, 932 (N.D. Cal. 1970).

241. The Restatement (Second) of Contracts was adopted and promulgated by the American Law Institute in 1979. See *RESTATEMENT (SECOND) OF CONTRACTS* (1981).