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## The Efficient Performance Hypothesis

**ABSTRACT.** Notable American jurists and scholars have advanced an approach to contract enforcement that would render breach legally and morally uncontestable, assuming compensation follows. Much of the justification for this endeavor has rested upon claims of judicial and economic efficiency. But efficiency neither favors nor disfavors this conception of contract, formalized by the efficient breach hypothesis. This Essay develops an alternative approach to contract enforcement, expressed as the efficient performance hypothesis. The alternative approach predicts the same efficiency as the traditional one, but differs starkly in terms of its ethical understanding of contractual obligation. The efficient breach hypothesis supposes that the promisor has the legal right—not merely the power—to choose to perform or pay damages. That right belongs to the promisee under the efficient performance hypothesis. These discrete conceptions of promissory obligation do not exhaust the possibilities of course, but taken together the hypotheses suggest that other conceptions of legal and moral obligation may be employed within an efficient enforcement framework.

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## **ESSAY CONTENTS**

<b>INTRODUCTION</b>	570
<b>I. MEANS AND AIMS OF CONTRACT ENFORCEMENT</b>	575
A. Assigning and Protecting Contractual Entitlements	575
B. Counterfactual Aims of Contract Remedies	577
<b>II. PROMISOR'S AND PROMISEE'S ELECTION</b>	579
A. Promisor's Election and Efficient Breach	579
B. Promisee's Election and Efficient Performance	581
C. Remedial Choices and Consequences	584
<b>III. ETHICS AND ECONOMICS</b>	587
A. Positive Confusion	587
B. Normative Clarity	591
<b>CONCLUSION</b>	595

## INTRODUCTION

Law and economics scholarship has advanced a number of provocative arguments in the name of efficiency—from promoting insider trading to establishing markets for babies—but none is perhaps quite so controversial as the argument behind the efficient breach hypothesis.<sup>1</sup> The idea that legally obligated parties ought to be encouraged to breach their contracts when it is in their self-interest to do so would seem to threaten a greater “social interest in the stability of promises as a social and economic institution.”<sup>2</sup> But as efficient breach advocates point out, promoting economic and social welfare is the very basis of the hypothesis. Furthermore, efficient breach does not, as often suggested, disallow enforcement of inefficient contracts. Rather, it supposes a system of strict enforcement of all contracts, regardless of their efficiency.<sup>3</sup> Enforcing a contract does not necessarily require the performance of the specified action; it may instead entail the imposition of penalties,<sup>4</sup> though as Richard Craswell observed, “this form of enforcement is rarely considered in the philosophical literature on promising, which usually assumes that promises must either (1) oblige the promisor to perform the promised actions, or (2) have no moral force at all.”<sup>5</sup> Efficient breach of contract occupies “an intermediate level of moral force.”<sup>6</sup>

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1. “Repudiation of obligations should be encouraged where the promisor is able to profit from his default after placing his promisee in as good a position as he would have occupied had performance been rendered.” Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970).
  2. ROSCOE POUND, AN INTRODUCTION TO THE PHILOSOPHY OF LAW 237 (1922). David Hume similarly urged “that promises are human inventions, founded on the necessities and interests of society,” without which “the commerce of [good] offices in a manner lost among mankind” would grind to a halt, leaving “every one reduc’d to his own skill and industry for his well-being and subsistence.” DAVID HUME, A TREATISE OF HUMAN NATURE bk. III, pt. II, § 5, at 519–20 (P.H. Nidditch ed., 2d ed. 1978) (1739–1740).
  3. See Richard Craswell, *Two Economic Theories of Enforcing Promises*, in THE THEORY OF CONTRACT LAW: NEW ESSAYS 19, 26–27 (Peter Benson ed., 2001).
  4. See, e.g., CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION 17 (1981) (“If I make a promise to you, I should do as I promise; and if I fail to keep my promise, it is fair that I should be made to hand over the equivalent of the promised performance. In contract doctrine this proposition appears as the expectation measure of damages for breach.”).
  5. Craswell, *supra* note 3, at 27.
  6. *Id.* One can choose not to perform, but one will then be liable. Scholars have attacked this theory as undermining the way in which we ought to understand a promise. See, e.g., Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1 (1989); Peter Linzer, *On the Amoralism of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L.

Moral force at this intermediate level, and no higher, was exactly what Justice Oliver Wendell Holmes identified in his celebrated essay *The Path of the Law*.<sup>7</sup> “The duty to keep a contract at common law,” Holmes proposed, “means a prediction that you must pay damages if you do not keep it, – and nothing else.”<sup>8</sup> From there followed his option theory of contract, which according to Richard Posner clarified the traditional view whereby “‘duty’ is vague, abstract. Holmes pointed out that in a regime in which the sanction for breach of contract is merely an award of compensatory damages to the victim, the entire practical effect of signing a contract is that by doing so one obtains an option to break it.”<sup>9</sup> Holmes supported his proposition with an extensive discussion of the old English case *Bromage v. Genning*.<sup>10</sup> While the court did voice concern about subverting the promisor’s intent that it be his choice to pay damages or perform,<sup>11</sup> it also expressed concern that if the promisor were ordered to perform and he refused, there was no remedy other than to imprison his body.<sup>12</sup> We are reminded that promisors have always had options. “Perform or

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REV. 111, 138-39 (1981). Yet most critics stop short of describing the efficient breach hypothesis as immoral or even amoral, as suggested above. Thomas Scanlon, for instance, advocates an obligation to perform, instead of an obligation to perform or pay damages, but does not claim that the alternative is morally unacceptable. Thomas M. Scanlon, *Promises and Practices*, 19 PHIL. & PUB. AFF. 199, 205 (1990).

7. O.W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) (“Nowhere is the confusion between legal and moral ideas more manifest than in the law of contract.”).
8. *Id.*
9. RICHARD A. POSNER, LAW, PRAGMATISM, AND DEMOCRACY 58 (2003).
10. (1616) 81 Eng. Rep. 540 (K.B.). In this case, “a prohibition was sought in the King’s Bench against a suit in the marches of Wales for the specific performance of a covenant to grant a lease.” Holmes, *supra* note 7, at 462.
11. “Coke said that [specific performance] would subvert the intent of the covenantor, since he intends it to be at his election either to lose the damages or to make the lease.” Holmes, *supra* note 7, at 462.
12. *Bromage*, 81 Eng. Rep. 540. This was “[t]he oldest method of enforcement in Roman law,” involving “seizure of the person, to coerce satisfaction or hold the promisor in bondage until his kinsmen performed the judgment.” POUND, *supra* note 2, at 239. This practice found its way into the common law and remained there through the nineteenth century. Alfred Avins, *Involuntary Servitude in British Commonwealth Law*, 16 INT’L & COMP. L.Q. 29 (1967); Richard Ford, *Imprisonment for Debt*, 25 MICH. L. REV. 24 (1926). Holmes himself was neither unfamiliar nor uneasy with the notion of criminal penalties for breach of contract. In response to Alabama’s peonage laws around the turn of the twentieth century, he observed that the Constitution, and apparently the common law, does not “prevent[] a State from making a breach of contract . . . a crime and punishing it as such.” *United States v. Reynolds*, 235 U.S. 133, 150 (1914) (Holmes, J., concurring); see also *Bailey v. Alabama*, 219 U.S. 219, 246 (1911) (Holmes, J., dissenting). Suggestions that Holmes had in mind the efficient breach hypothesis (which is predicated on expectation damages) are undermined

pay” and “perform or prison,” however, merely describe economic choices; they say nothing about the legal character of these options. The power to perform or pay is not the same as the right to perform or pay. All duties, at some level, are optional, making “perform or pay” a rather weak conception of duty. I am of course not the first to observe this gossamer notion of duty (Holmes himself expressed this criticism).<sup>13</sup> But I shall advance here that it has little to do with economic efficiency.

Avoiding specific performance of inefficient contracts creates value. Think of it as a contractual opportunity, which—like partnership opportunities—can be viewed as belonging to the joint venturers (the promisor and promisee in this case). Without saying more, it remains morally ambiguous to whom the gains of this opportunity should go, or whether they should be shared and, if so, how. Efficiency considerations offer equally ambiguous guidance. Even a concern for allocative efficiency alone does not provide an a priori justification for giving promisors the gains of nonperformance. The fact that nonperformance of an existing contractual obligation is sometimes efficient—which is to say, it sometimes produces more gains than performance—is analytically distinct from a rule giving the promisor an option to acquire those gains.

Here is where the controversy over the efficient breach hypothesis lies. It is not in the suggestion that some promises need not be kept. By almost every normative criterion, not all promises should be kept. Doctrine excusing performance for frustration of purpose, for instance, does not provoke moral outrage. What provokes disapproval of the efficient breach hypothesis are strong moral sentiments that nonperformance of a contractual promise is not a right, but in fact is a wrong, and that promisors should not profit from the

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by—though not entirely inconsistent with—his embrace of punitive remedies for breach of contract.

13. The consequentialist understanding of duty expressed in *The Path of the Law* is properly attributed to the Holmesian bad man and not directly to Holmes, as he was “speaking from the bad man’s point of view.” Holmes, *supra* note 7, at 461. Indeed, many years earlier, Holmes explicitly rejected this understanding of legal duty: “A legal duty cannot be said to exist if the law intends to allow the person supposed to be subject to it an option at a certain price.” [Oliver W. Holmes, Jr.], *The Law Magazine and Review*, 6 AM. L. REV. 723, 724 (1872) (reviewing [Frederick Pollock], *Law and Command*, 1 LAW MAG. & REV. 189 (1872)), reprinted in 1 THE COLLECTED WORKS OF JUSTICE HOLMES 294, 296 (Sheldon M. Novick ed., 1995). Holmes viewed nonperformance of contract as a legal wrong that compelled compensation. Paying compensation was not in his view an alternative form of performance or a legal right to which promisors were entitled. See Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085, 1086–89 (2000).

unilateral exercise of their power to perform or not. Yet that distribution of profit and power is not required for allocative efficiency.

This Essay develops an efficient performance hypothesis, structured to give the promisee the right to compel performance and capture all or some of the profits when nonperformance is elected. The key to this approach is situating the promisee to weigh the marginal costs and benefits of performance. That is exactly what the efficient breach hypothesis accomplishes with regard to the promisor. For the promisee, the efficient performance hypothesis can work just as well by giving her the choice between performance and disgorgement of the promisor's cost as the remedy for breach.<sup>14</sup> Indeed, this hypothesis predicts the same allocatively efficient outcome as the efficient breach hypothesis but offers a distribution of rights and gains that is more consistent with the moral sentiments described above.

Allocative efficiency does not call for any particular allotment of rights and surplus. The First Theorem of Welfare Economics established this claim long ago.<sup>15</sup> With specific reference to contract, scholars have shown generally (and quite dramatically) that efficiency is achievable over a continuum of allocative rights and distributions of surplus—the possibilities are literally infinite.<sup>16</sup> The purpose of this Essay, however, is not to reiterate the basic principles of welfare economics or the compelling work on the optimal design of liability rules. Rather, it is to show that efficiency is consistent with more robust notions of contractual duty than those employed by the Holmesian bad man.<sup>17</sup> Stronger forms of enforcement, such as giving the promisee the right to elect specific

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14. In other words, the promisee is made to consider the value (through performance) and the cost (through disgorgement) of contract performance. Trading off value and cost in this way, the promisee will elect contract performance only if it is efficient. This is just what the promisor does under the efficient breach hypothesis, which situates the promisor to consider the value (through expectation damages) and the cost (through performance) of contract performance.
  15. Harold Hotelling, *The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates*, 6 *ECONOMETRICA* 242 (1938).
  16. See IAN AYRES, *OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS* (2005). In torts, Guido Calabresi and Jon Hirschoff illustrated this point with their reverse Learned Hand rule. Guido Calabresi & Jon T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 *YALE L.J.* 1055, 1059 (1972).
  17. The Holmesian bad man refers to a legal actor who is not driven by his conscience or morality, but who rather “finds his reasons for his conduct” in predictions of the material consequences that are likely to follow. Holmes, *supra* note 7, at 459. Thus, Holmes's bad man is akin to Hume's knave: “[I]n contriving any system of government . . . every man ought to be supposed to be a knave, and to have no other end, in all his actions, than private interest.” DAVID HUME, *Of the Independency of Parliament* (1741), in *ESSAYS: MORAL, POLITICAL AND LITERARY* 40, 40 (Oxford Univ. Press 1963).

performance or supracompensatory damages, can allow for optimal allocation of resources while achieving a higher degree of moral force than the intermediate level associated with efficient breach.

Part I lays out the basic taxonomy (and derived rules) of entitlement assignment and protection set forth by Guido Calabresi and Douglas Melamed as well as the contract damage scheme suggested by Lon Fuller and William Perdue. Together these approaches introduce the fundamental ways in which courts may combine various rules with damage awards in crafting a remedy. Part II then develops the structural framework of the Essay. This framework associates contractual enforcement with the triple  $\{e, d, m\}$ , in which  $e$  represents the entitlement holder,  $d$  denotes who has the legal right to allocate the entitlement, and  $m$  is the measure of damages paid to the entitlement holder when the entitlement is allocated away from her.

Isolating  $e$ ,  $d$ , and  $m$ , and then considering their interaction, allows for a somewhat more explicit understanding of contract enforcement, efficiency, and distribution. For instance, when the promisee is the entitlement holder ( $e$ ), the efficient breach hypothesis implicitly assigns the allocative decision ( $d$ ) to the promisor and sets damages ( $m$ ) to the expectation measure. Given this setup, the marginal gains and losses associated with allocation accrue entirely to the promisor, who therefore has an incentive to allocate (i.e., to perform or not) efficiently. This structure also makes plain the efficient performance hypothesis, which assigns the entitlement ( $e$ ) and the allocative decision ( $d$ ) to the promisee and allows a variety of damage measures ( $m$ ), from expectation to disgorgement. Observe that  $e$ ,  $d$ , and  $m$  operate simply as identifiers. Part II's analysis does not focus on how, as a general matter,  $e$ ,  $d$ , and  $m$  should be assigned.<sup>18</sup> Part III does, however, address the normative implications of entitlement assignment ( $e$ ) and allocation rights ( $d$ ). The categorical damage measures ( $m$ ), it turns out, are not particularly relevant for the argument advanced here.

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18. For a comprehensive discussion of how  $d$  and  $m$  should be assigned given the objective of efficiency, see AYRES, *supra* note 16. Ian Ayres does touch on the assignment of  $e$ , particularly in the torts context, but the efficiency justifications for promissory entitlement assignment are more difficult to maintain. See *infra* note 21 and accompanying text.

## I. MEANS AND AIMS OF CONTRACT ENFORCEMENT

This Part merges the contract remedy taxonomy originated by Fuller and Perdue (expanded by Avery Katz)<sup>19</sup> with the taxonomy of property rules and liability rules developed by Calabresi and Melamed (expanded by Ian Ayres).<sup>20</sup> The former focuses on a court's aims in terms of situating one or both parties following a breach, while the latter addresses the means available to a court to implement these aims. These means and aims combine to create a dense remedial regime.

### A. Assigning and Protecting Contractual Entitlements

Let's begin with Calabresi and Melamed's dichotomy of how law assigns and protects legal entitlements. In a dispute between *A* and *B*, a court may assign the entitlement to either *A* or *B*. The court's choice of entitlement assignment (*e*) is not usually the subject of welfare analyses.<sup>21</sup> The assignment of *e*, represented by the rows in Figure 1, is typically seen as predetermined by existing legal relations, which the court is simply asked to identify without regard to efficiency or other welfare considerations. The columns in Figure 1 show the court's choices for how to protect the entitlement: a property rule and a liability rule. Property rules protect entitlements by using the state's police powers to prohibit nonconsensual appropriations, whereas liability rules use court-determined monetary compensation to discourage nonconsensual appropriations. The matrix of entitlement assignment and protection reveals four general rules that are available to judges for resolving disputes.

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19. L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52, 61 (1936); Avery Katz, *Reflections on Fuller and Perdue's The Reliance Interest in Contract Damages: A Positive Economic Framework*, 21 U. MICH. J.L. REFORM 541 (1988).
  20. AYRES, *supra* note 16; Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).
  21. That is, unless the court proposes to enforce only ex post efficient contracts and the like, a proposition that few would seriously defend. But efficiency may be a useful criterion when addressing the costs associated with entitlement assignment. The court may favor rules that minimize the costs of creating and identifying legally enforceable promises. For example, when there is uncertainty over the assignment, the court may well use efficiency to temporarily assign an entitlement pending its determination. See, e.g., Richard R.W. Brooks & Warren F. Schwartz, *Legal Uncertainty, Economic Efficiency, and the Preliminary Injunction Doctrine*, 58 STAN. L. REV. 381 (2005). Similarly, courts sometimes void otherwise enforceable contracts based on policy considerations or justice concerns, such as those embodied in the unconscionability doctrine.



Figure 1.

		FORM OF ENTITLEMENT PROTECTION	
		PROPERTY RULE	LIABILITY RULE
ENTITLEMENT HOLDER	A (PROMISEE)	Rule 1	Rule 2
	B (PROMISOR)	Rule 3	Rule 4

The four rules are typically illustrated with a pollution nuisance dispute, but a breach of contract dispute works just as well.<sup>22</sup> Assume that *B* (the promisor) has declined to honor a promise made to *A* (the promisee). The court may determine that the promisor is obligated to keep the promise (i.e., it may assign the promissory entitlement to the promisee) and protect the promisee's entitlement either by invoking the state's police powers (Rule 1) or by ordering the promisor to pay money damages to the promisee (Rule 2). Alternatively, the court may assign the entitlement to the promisor (i.e., it may allow the promisor to avoid the promissory obligation) and protect that assignment either by invoking the state's police powers (Rule 3) or by ordering the promisee to pay monetary compensation if she appropriates the promisor's entitlement (Rule 4).

The square matrix suggested by Calabresi and Melamed remained undisturbed for two decades, until scholars recognized that the liability rule structure was essentially a call option.<sup>23</sup> That is, one party has the legal right to purchase the other's entitlement without her consent. As one of the principal contributors to this reconceptualization of Rules 2 and 4 has observed, "Once the traditional liability rules were reconceived as granting a potential taker a call option, it became almost inevitable that scholars would wonder whether put-option rules might not also be desirable."<sup>24</sup> The mirror image of call

22. Indeed, explicit contractual illustrations may be distinctly useful. See Carol M. Rose, *The Shadow of the Cathedral*, 106 YALE L.J. 2175 (1997) (arguing that while nuisance is frequently offered as the motivating example in discussing the four rules, the true motivation often lies in other areas of the law, such as contracts and the law of accidents, and that the cost of these shadow examples has been an unfortunate blurring of legal principles).

23. See, e.g., AYRES, *supra* note 16; Ronen Avraham, *Modular Liability Rules*, 24 INT'L REV. L. & ECON. 269 (2004); Ian Ayres & Paul M. Goldbart, *Optimal Delegation and Decoupling in the Design of Liability Rules*, 100 MICH. L. REV. 1 (2001); James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N.Y.U. L. REV. 440 (1995); Madeline Morris, *The Structure of Entitlements*, 78 CORNELL L. REV. 822 (1993).

24. AYRES, *supra* note 16, at 15.

options, put options give parties the right to sell their entitlements to others without their consent.

The options framework expands Calabresi and Melamed’s matrix, modeling Rules 2 and 4 as call options and introducing two new rules, Rules 5 and 6, as put options. Thus under Rule 2, the promisor (*B*) has a call option to take the promisee’s (*A*’s) entitlement at an option price determined by the court. Rule 5 gives the promisor a put option, allowing her to make the promisee pay her a court-determined amount for some performed promise. Rules 4 and 6 may be similarly defined with respect to the promisee. Rule 4 is simply a call option for the promisee, which allows her to buy the promisor’s entitlement (i.e., to avoid promissory obligation) at an option price determined by the court. Finally, Rule 6 gives the promisee a put option, allowing her to force the promisor to buy her entitlement to promissory performance for a court-determined amount. Figure 2 updates Calabresi and Melamed’s matrix by incorporating the new rules.

Figure 2.

		FORM OF ENTITLEMENT PROTECTION		
		PROPERTY RULE	LIABILITY CALL	LIABILITY PUT
ENTITLEMENT HOLDER	A (PROMISEE)	Rule 1	Rule 2	Rule 6
	B (PROMISOR)	Rule 3	Rule 4	Rule 5

*B. Counterfactual Aims of Contract Remedies*

The framework above suggests possible approaches (rules) that courts may use to assign and protect entitlements. But it doesn’t tell us what the court is attempting to do when remedying breaches, or how the court should choose among these rules given its objectives. Rules 1 through 6 may be combined with different damage awards to generate a dizzying array of choices. For example, a Rule 2 call option for the promisor could be combined with different money damage awards (which effectively set the option price), just as a Rule 6 put option for the promisee may be joined with various damage measures. I will have more to say about these configurations later, but for the moment, rather than focusing on specific option-damage combinations, it is worthwhile to consider the court’s objectives in crafting these remedies.

In general, the court seeks to undo the effect of either the breach or the promise on one or both parties. In other words, the court is attempting to

realize the equivalent of some counterfactual state. For example, the court may use property rules such as specific performance, which places both parties in the positions they would have been in had there not been a breach, or rescission and cancellation (assuming no reliance expenditures), which place the parties in the positions they would have enjoyed had there not been a contract. Liability rules may be similarly combined with various damage awards to achieve these counterfactual states. Figure 3 highlights the four primary objectives that the court may pursue when remedying a breach of contract. As the top row shows, expectation damages place the promisee in the position she would have been in had the contract been performed, while reliance undoes the effect of the promise from the promisee’s perspective. The bottom row focuses on the promisor, with disgorgement achieving the counterfactual no-breach state and restitution (narrowly construed) achieving the counterfactual no-promise state. Any of these four remedies (and others) may be combined with any of the four liability rules (Rules 2, 4, 5, and 6).

Figure 3.

		COUNTERFACTUAL STATE	
		NO BREACH	NO PROMISE
RELEVANT PARTY	PROMISEE	Expectation	Reliance
	PROMISOR	Disgorgement	Restitution

In undoing the breach or the promise, the court may be motivated by a number of normative justifications including autonomy, corrective and distributive justice, cooperation, fairness, and efficiency. With regard to efficiency, there are three stages at which parties make choices that have efficiency implications: the ex ante stage, when parties decide whether to enter into contracts; the interim stage, when contracts have been formed but are not yet complete, parties decide whether to rely (or invest) based on their agreements and the enforcement regime; and the ex post stage, when parties decide whether to perform or breach contracts. While no single rule/damage-award combination leads to efficiency in all three stages (or even just two) with respect to both promisee and promisor, the Rule-2/expectation-damages combination—the focus of the efficient breach hypothesis—has held a special place in the literature on contract remedies, and it is not hard to see why. Rule 2, which assigns the call option to the promisor, is motivated by the efficiency it produces (given the damage award), and the expectation damage award, which ensures that the promisee is no worse off from the breach, is motivated

by the weakly Pareto-superior outcome that is realized (given the call option). But the unique prominence afforded this rule-damage combination is unwarranted. As the next two Parts show, there are other combinations that are equally efficient and potentially more consistent with the other normative understandings of contract enforcement.

## II. PROMISOR'S AND PROMISEE'S ELECTION

The following hypothetical is used to motivate the analysis. Take two parties—a buyer (*B*) and seller (*S*)—who have entered a contract in which *B* agrees to pay *S* a price of  $P = \$12,000$  in exchange for *S*'s car, which *B* values at  $v_B = \$15,000$ . (Assume that *S* places no direct value on the car; i.e.,  $v_S = \$0$ .) Ex ante, therefore, this is an efficient agreement. Transferring \$12,000 from *B*'s pockets to *S*'s creates no efficiency implications—it is purely distributional—but when the car moves from *S* to *B*, \$15,000 of wealth is created. Let's say that *B* pays *S* upfront and then, in expectation of getting the car a month later, *B* rents a parking space for \$200 (nonrefundable).<sup>25</sup> Now imagine that before *S* delivers the car, a competing buyer (*C*) offers a higher price for the car. The competing buyer offers *S* either \$13,000 or \$20,000. For simplicity, assume that these prices reflect the competing buyer's full value of the car, that is, either  $v_C = \$13,000$  or  $v_C = \$20,000$ .

### A. Promisor's Election and Efficient Breach

The efficient breach hypothesis is premised on the Holmesian option theory of contract obligation: “The duty to keep a contract at common law means . . . you must pay damages if you do not keep it.”<sup>26</sup> Translating this observation into the taxonomy of entitlement protection described above, one could say that Holmes viewed promisees' entitlements as protected by Rule 2. The Rule 2 option combined with expectation damages led law and economics scholars in the early 1970s to recognize the efficient breach hypothesis<sup>27</sup>—

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25. Assume that without the parking space rental, the car is worth significantly less to *B* (say, \$12,500).

26. Holmes, *supra* note 7, at 462.

27. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 56-59 (1972); John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 277 (1972); Birmingham, *supra* note 1; Robert L. Birmingham, *Damage Measures and Economic Rationality: The Geometry of Contract Law*, 1969 DUKE L.J. 49; 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 (1977).

namely, that promisors under this regime will exercise their call options (i.e., their options to breach and pay damages) only when breaching is efficient.

The efficient breach hypothesis is straightforwardly illustrated with the buyer-seller hypothetical from above. Because the buyer pays upfront, the analysis can focus on the seller's decision to perform or breach. If  $C$  values the car at  $v_C = \$20,000$ , then allocative efficiency disfavors the car's going to  $B$  (because  $v_C > v_B$ ), and  $S$  should breach; but if  $C$  values the car at  $v_C = \$13,000$ , then social optimality—measured in terms of allocative efficiency—requires  $S$  to perform the contract (because  $v_B > v_C$ ). The seller, however, does not make the breach decision based on what is socially optimal. She will breach if and only if her expected cost of performance (i.e., the opportunity cost based on the forgone chance to sell to  $C$ ) is greater than her expected cost of breach, which is determined by the court remedy for breach.

Recall the remedies suggested earlier and assume that the entitlement is assigned to  $B$ . The court has at its disposal four principal money damage remedies: (1) *restitution*, whereby the court orders  $S$  to return  $B$ 's upfront payment (\$12,000); (2) *reliance*, whereby the court orders  $S$  to return  $B$ 's upfront payment plus her reasonable expenditures in reliance on the contract (\$12,200); (3) *expectation*, whereby the court orders  $S$  to pay  $B$ 's value of performance (\$15,000); and (4) *disgorgement*, whereby the court orders  $S$  to disgorge the gains received from the breach of the contract (\$13,000 or \$20,000). Table 1 summarizes the payoff to the parties under these four damage remedies when the contract is not performed.

**Table 1.**  
BUYER'S AND SELLER'S NONPERFORMANCE PAYOFFS (IN DOLLARS) UNDER VARIOUS DAMAGE REMEDIES

REMEDY	HIGH-VALUE $C$ ( $v_C = 20,000$ ) NONPERFORMANCE PAYOFFS			LOW-VALUE $C$ ( $v_C = 13,000$ ) NONPERFORMANCE PAYOFFS		
	$\pi_B$	$\pi_S$	$\pi_B + \pi_S$	$\pi_B$	$\pi_S$	$\pi_B + \pi_S$
Restitution	12,000	20,000	32,000	12,000	13,000	25,000
Reliance	12,200	19,800	32,000	12,200	12,800	25,000
Expectation	15,000	17,000	32,000	15,000	10,000	25,000
Disgorgement	20,000	12,000	32,000	13,000	12,000	25,000

As a point of departure, note that when the contract is performed, the joint payoff for  $B$  and  $S$  is \$27,000.<sup>28</sup> Allocative efficiency therefore requires nonperformance of the contract when  $v_C = \$20,000$  (because, as shown in Table 1, the nonperformance joint payoff is \$32,000) and performance when  $v_C = \$13,000$  (because then the nonperformance joint payoff is only \$25,000).<sup>29</sup> But again, the seller does not compare the joint (i.e., social) payoffs from performance and breach. When deciding whether to perform or breach,  $S$  compares her individual payoff from performance (receiving \$12,000 from  $B$ ) to her individual payoff from breach given the court-determined remedies (shown in the columns labeled  $\pi_S$ ). Whenever  $\pi_S > \$12,000$ ,  $S$  will breach. Table 1 shows that only the expectation remedy leads  $S$  to perform and breach efficiently in all cases. The expectation remedy forces  $S$  to internalize the value of performance (by setting damages equal to  $B$ 's value) when considering the cost of performance (her opportunity costs of not selling to  $C$ ).

### *B. Promisee's Election and Efficient Performance*

Marginal value and cost comparisons are the keys to determining efficient behavior. It matters little who is making the comparisons, as long as they are being made accurately. Courts can make the comparison. Promisors can as well, as indicated by the efficient breach hypothesis. Even promisees can be put in a position to make the appropriate comparisons. When a promisee is given the option to decide whether the contract should be performed, she too can be forced to internalize the other party's costs. To see how this can be achieved, consider again the entitlement options framework set forth in Figure 4. If the promisee is assigned the entitlement, then it quickly becomes apparent that specific performance (Rule 1) and Holmes's call option (Rule 2) are not the only ways that the promisee's entitlement may be protected. This framework reminds us to keep our eyes open for "puts" whenever we observe "calls." But how might Rule 6 be operationalized in this context? Imagine that the promisee, instead of seeking specific performance, could force the promisor not to perform and could then make her pay damages for breach.

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28. This is the gross joint payoff for the parties (i.e., not including reliance payments). The net joint payoff is \$14,800:  $S$  gets \$12,000 and  $B$  nets \$2800 ( $\$15,000 - \$12,200$ ).

29. The payoff to  $S$  from nonperformance is derived by adding the payments  $S$  receives from  $B$  and  $C$  ( $\$12,000 + \$20,000$  or  $\$12,000 + \$13,000$ ), and subtracting the amount that  $S$  would have to pay  $B$  in damages for breaching.  $B$ 's payoffs are calculated by considering what she would get through the court remedy as described above. The net joint payoff is \$19,800 when  $v_C = \$20,000$  and \$19,800 when  $v_C = \$20,000$ .

Figure 4.

**REMEDIAL OPTION FOR PROMISEE**

PROPERTY RULE	LIABILITY CALL	LIABILITY PUT
Rule 1	Rule 2	Rule 6

It may seem a little odd to think of promisees forcing promisors to breach their promises and then making them pay for the breach (and, indeed, there is extensive case law discouraging the practice of induced breach). However, the idea that promisees should be given the choice among remedies, including performance of the contract (specific performance) or payment (money damages), when the promisor breaches is not so strange.<sup>30</sup> Nor is it novel. With regard to contracts involving real property, courts often offer promisees the option of receiving damages or performance. The same option was long ago suggested for chattel transactions. “Judge Story urge[d] that there is no reasonable objection to allowing the party who is injured by the breach of any contract for the sale of chattels to have an election either to take damages at law or to have specific performance in equity.”<sup>31</sup> More recently, Alan Schwartz has argued (based on efficiency considerations) that promisees should have the option of electing specific performance or expectation damages when promisors breach.<sup>32</sup>

Yet notice that Schwartz’s put option for promisees—that is, giving the promisee the option of compelling performance or getting expectation

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30. This approach should be viewed, not as a pure put option for the promisee, but as what Ayres calls a Dual Chooser Rule, whereby the promisor’s initial action (choice) can trigger the promisee’s put option. For example, the promisor might first cause the promisee to demand assurances or breach anticipatorily, which allows the put option to come about. These are also called higher-order liability rules. See AYRES, *supra* note 16, at 34, 96-98.

31. *Curtice Bros. v. Catts*, 66 A. 935, 935-36 (N.J. Ch. 1907) (citing 2 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE AS ADMINISTERED IN ENGLAND AND AMERICA § 717a, at 36 (Melville H. Bigelow ed., Boston, Little, Brown & Co. 13th ed. 1886)). Perhaps service contracts are the exception, and this can be accounted for by moral hazard and Thirteenth Amendment concerns.

32. See Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 291 (1979) (“Making specific performance more widely available at the election of the promisee would not result in more costly pre- or post-breach negotiations than the damage remedy does at present.”). Schwartz has also argued that “[f]urther expanding of the availability of specific performance would produce certain efficiency gains: it would minimize the inefficiencies of undercompensation, reduce the need for liquidated damage clauses, minimize strategic behavior, and save the costs of litigating complex damage issues.” *Id.*

damages—does not generate the same allocatively efficient outcomes as Holmes’s call option for promisors (with expectation damages). Allowing the promisee to choose between performance and expectation damages does not achieve an efficient tradeoff: if the promisee elects performance, then she gets the full benefit of that performance ( $v$ ); if the promisee does not elect performance, then she gets an amount equivalent to the benefit that she would have appreciated from performance ( $v$ ). This tradeoff between  $v$  from performance and  $v$  from money damages does not situate the promisee to allocate the entitlement efficiently because the cost of performance ( $c$ ) is never taken into account.<sup>33</sup> What is attractive about the Holmesian option and the efficient breach hypothesis is that the party making the decision about the allocative outcome (i.e., the promisor) is situated to weigh the costs and the benefits of that decision. If the promisor performs, she must pay the cost of performance ( $c$ ); if the promisor does not perform, she must pay the other party an amount equivalent to the benefit that party would have appreciated from performance ( $v$ ). That is the tradeoff (i.e.,  $v \geq c$  or  $v < c$ ) on which the efficient breach hypothesis relies and functions.

But specific performance at the election of the promisee may still have the same efficiency implications attributed to the promisor’s option in the efficient breach literature. As a general matter, there is nothing unique or special about promisors’ knowledge that requires the option to be placed with them. In theory, one could just as easily construct an efficiency-inducing option for promisees by giving them the option to compel performance or to be paid damages. The promisee’s option described above may lead to inefficiency—not because it is the promisee who makes the choice, but because the promisee is not optimally situated when making that choice. Appropriately determined damage awards, however, can encourage promisees to compel performance when and only when it is efficient.

To achieve this efficiency, the appropriate damage award turns out to be the familiar remedy of disgorgement. By giving the promisee the option of compelling performance and getting  $v$  or being paid the breacher’s (opportunity) cost of performance ( $c$ ), the promisee is situated to make the

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33. Beyond inefficient allocation, Schwartz has observed that one might object to the promisee’s option on other efficiency grounds (i.e., costly supervision), *see id.* at 292–96, or on moral grounds (i.e., concerns about promisors’ liberty), *see id.* at 296–98. Of course, efficiency (e.g., investment) and morality charges are also issued against the efficient breach hypothesis. The promisee’s option argument does, however, serve an important compensation function, and providing adequate compensation was the basis of Schwartz’s argument: “Because the normative goal of contract remedies is compensation, specific performance should lie unless it can be shown that the costs of specific performance would exceed the gains.” *Id.* at 294.



optimal tradeoff (i.e.,  $v \geq c$  or  $v < c$ ).<sup>34</sup> Table 1, again, illustrates. When deciding whether to compel the promisor's performance, the promisee ( $B$  in this case) compares her individual payoff from performance (which she values at \$15,000) to her individual payoff from nonperformance coupled with damages. And by equating damages with the promisor's cost of performance, the court situates the promisee to make the efficient tradeoff. Under this regime (Rule 6 with disgorgement remedy), the promisee will compel performance when and only when it is allocatively efficient: the efficient performance hypothesis.

### C. Remedial Choices and Consequences

The efficient performance hypothesis is not in its economic consequences superior or inferior to the traditional efficient breach hypothesis. They are, in a sense, complements. In one case, the court must determine the breacher's cost; in the other, it must determine the nonbreacher's value. Depending on its knowledge, the court may be in a better position to determine one or the other. In one case the nonbreacher gets the surplus from nonperformance of the original contract, while in the other case the breacher captures the surplus. Given this distributional difference, preference shown to the breacher or to the nonbreacher may serve additional efficiency or fairness considerations.<sup>35</sup> But economic considerations cannot tell us a priori which is the better approach.

The efficient performance hypothesis may at first appear to sit uneasily with conventional views of the disgorgement remedy, which has received considerable recent attention in the United States and other common law jurisdictions.<sup>36</sup> Critics of this remedy have advanced both economic and ethical

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34. In other words, the promisee is given the option to elect either specific performance or disgorgement as the remedy.
35. Investment efficiency may, for instance, be served by assuring one party more of the surplus.
36. Much has been written about a possible expansion of disgorgement as a standard remedy for breach of contract, as signaled in a string of recent cases in the United States, Canada, England, and Israel. *E.g.*, *EarthInfo, Inc. v. Hydrosphere Res. Consultants, Inc.*, 900 P.2d 113 (Colo. 1995); *Bank of Am. Can. v. Mut. Trust Co.*, [2002] 2 S.C.R. 601 (Can.); CA 20/82 *Adras Bldg. Material Ltd. v. Harlow & Jones GmbH* [1988] IsrSC 42(1) 221, translated in 3 *RESTITUTION L. REV.* 235 (1995); *Attorney Gen. v. Blake*, [2001] 1 A.C. 268 (H.L.) (appeal taken from Eng.) (U.K.); see, e.g., Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 *YALE L.J.* 1339 (1985); Daniel Friedmann, *Restitution of Profits Gained by Party in Breach of Contract*, 104 *LAW Q. REV.* 383 (1988); Andrew Kull, *Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts*, 79 *TEX. L. REV.* 2021 (2001); Ernest J. Weinrib, *Punishment and Disgorgement as Contract Remedies*, 78 *CHI.-KENT L. REV.* 55, 74 (2003).

challenges; I address the former here and the latter in Part III of this Essay. Two principal economic efficiency arguments have been made against disgorgement. The first, which seems to me entirely implausible, suggests that the evidentiary burden of establishing the disgorgement remedy is greater than that associated with expectation damages. The belief that economic values of promisees are more easily determined than those of promisors is simply unfounded.<sup>37</sup> One can easily imagine cases in which the value of nonperformance to the promisor (e.g., a seller), or her cost of performance, is more readily established than the value of performance to the promisee (e.g., a buyer). Indeed, a seller's cost of procuring an item will in many cases be easier to establish than the value a buyer places on the item.

The second efficiency argument against disgorgement is equally unpersuasive: "Whereas the traditional rule provides the promisor with an incentive to redirect resources efficiently, a broad restitutionary rule [like disgorgement] tends to diminish this incentive . . . ."<sup>38</sup> Because disgorgement does not reward the promisor for her efforts in finding valuable opportunities, the argument goes, opportunities that are exploitable under the traditional rule would not be realized under the alternative approach. But note that this argument presupposes that the promisor is better situated than the promisee to redirect resources efficiently, a supposition that may or may not be true. While promisors can often better identify alternative uses and users than promisees, there are numerous situations in which the promisees—who are, for example, wholesale or retail buyers—have better access to markets of uses and users. This empirical squabble need not distract us too much, however, because a simple modification of the damage amount under the efficient performance hypothesis will preserve the parties' incentives to redirect resources efficiently.

Let's grant that the promisor is the more efficient identifier of valuable opportunities. To leave her indifferent between identifying and not identifying

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37. Hanoch Dagan, for instance, notes that "[i]n order to recover the promisor's profits [i.e., disgorgement], the promisee is required to submit evidence regarding another's affairs." HANOCH DAGAN, *THE LAW AND ETHICS OF RESTITUTION* 275 (2004). What is relevant, however, is not that which is observed, but that which can be verified. A promisee may know with certainty her own value, but she will nonetheless face high evidentiary costs if she cannot sufficiently establish this value in court; similarly, she may have only an approximate knowledge of the promisor's profits (or opportunity costs of performance) but may be able to verify important aspects of them at low cost. Dagan further observes that disgorgement "requires that difficult judgments be made regarding causation as well as attribution of specific profits (and, presumably, also costs) to one specific transaction out of all the undertakings of the promisor." *Id.* It is difficult to see why these issues of causation and attribution would be a priori more pronounced when determining the value of one party or another.

38. *Id.* at 273. Note that Dagan does not give this argument much credence.

these opportunities, the disgorgement payment may simply be reduced to allow the promisor to recover her identification (or search) costs.<sup>39</sup> This recovery, of course, must be limited to reasonable costs. Reimbursement of search costs should not exceed the social surplus from searching; in other words, the promisor's recovery must be capped by the difference between the value of the performance to the promisee and the value of the efficient alternative use. Interestingly enough, there is common law support for this modified form of disgorgement,<sup>40</sup> but the key point for present purposes is that the modified measure ensures that the right incentives exist for the promisor under the efficient performance hypothesis, without compromising the efficiency of the promisee's allocative decision.

Similarly, when promisees are better identifiers, comparable modifications may be undertaken to produce optimal incentives under the efficient breach hypothesis.<sup>41</sup> Together these hypotheses suggest some flexibility for courts in pursuit of various consequentialist goals, and one approach cannot be said to trump the other in this regard. They are comparably efficient. The same, however, cannot be said about the moral implications of the approaches. While the efficient breach hypothesis runs counter to broadly held moral intuitions about promises and contracts, the efficient performance hypothesis satisfies these intuitions, or at least does not contradict them. I shall establish this proposition in the remainder of this Essay.

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39. Note that indifference is sufficient: compensating the promisor with more than her search costs when she identifies the exploited alternative opportunity is unnecessary for efficiency (alternatively, the promisor may be offered her identification costs plus some very small amount,  $\epsilon > 0$ , where  $\epsilon \rightarrow 0$ ).
40. Recall the well-known English case *Boardman v. Phipps*, [1967] 2 A.C. 46 (H.L.) (appeal taken from Eng.), in which a trustee generated significant profits for a trust, but also for himself in contravention of the trust agreement. While the court ordered the fiduciary to disgorge all profits, it nonetheless allowed him to retain a portion that would serve as compensation for his efforts in identifying the valuable opportunities. The law here is somewhat mixed, allowing recovery in some cases and denying it in others. See, e.g., RESTATEMENT (SECOND) OF AGENCY §§ 404, 407 (1958); see also RESTATEMENT (THIRD) OF AGENCY § 8.02 cmt. e (2006) (reiterating this position).
41. These modifications, however, are not without costs. Using a remedy other than disgorgement with the efficient performance rule (or expectation damages with the efficient breach rule) places an additional burden on the court of determining the transfer amount to the non-choosing party.

### III. ETHICS AND ECONOMICS

Almost everyone who has anything to say about the subject agrees that, as a general matter, people have a moral obligation to keep their promises.<sup>42</sup> Moving from promise to contract, commentators are conflicted about whether—and under what circumstances—breaching a contract constitutes breaking a promise, rendering the breach immoral. This conflict is played out most prominently in debates about efficient breach. But the vast majority of the normative arguments for and against efficient breach seem to be based on a positive claim regarding what constitutes a contractual promise. Unfortunately, the commentary on both sides of the debate is marred by a lack of explicit attention to this claim. The result is that commentators, when making normative arguments about efficient breach, tend to talk past one another.

#### A. Positive Confusion

Supporters of efficient breach typically argue—often with little justification—that by contracting, the promisor intends either to perform (those deeds set forth or implied in the contract) or to pay damages for nonperformance. Under this view, nonperformance of the stipulated deeds, followed by payment of damages to the promisee, does not amount to promise-breaking in a practical sense—nor in an ethical sense, because the promise *is* to “perform deeds or pay damages.”<sup>43</sup> Opponents of efficient breach

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42. Various moral theories provide different accounts of why we have a moral obligation to keep our promises. See HUME, *supra* note 2; IMMANUEL KANT, *THE METAPHYSICS OF MORALS* 6:304–:305 (Mary Gregor ed. & trans., 1996) (1797); JOHN RAWLS, *A THEORY OF JUSTICE* (rev. ed. 1999); David Owens, *A Simple Theory of Promising*, 115 *PHIL. REV.* 51 (2006); T.M. Scanlon, *Promises and Contracts*, in *THE THEORY OF CONTRACT LAW*, *supra* note 3, at 86.

43. One might think of the contractual promise in terms of a fill-in-the-price mechanism that includes a price and quantity-quality schedule for all possible states. See, e.g., Benjamin K. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 *J.L. ECON. & ORG.* 230 (1993); Akira Konakayama et al., *Efficient Contracting with Reliance and a Damage Measure*, 17 *RAND J. ECON.* 450 (1986). Imagine a simple contract between a buyer and a seller for the delivery of some specified units of a good for a specified price. The “sophisticated” parties described by these authors do not settle for these simple contracts; they also specify prices associated with other delivered quantities, including zero units (“nonperformance”) and more units than expected. In this way, the parties really cannot breach contracts, and all that is left for the court to do is to specifically enforce the mechanism if any party does not do her part. The problem with this approach, however, is that contracts are necessarily incomplete, even when written by sophisticated parties. But while contracts are *ex ante* incomplete, after the

tend to disagree with this description of what is promised in a contract. They argue that by contracting, the promisor agrees to perform (those deeds set forth or implied in the contract). Although they allow for the possibility that the promisor may not perform—i.e., that performance may be validly excused, or that legal and moral sanctions may follow nonperformance—they contend that the promise itself does not have payment as a built-in contingency for nonperformance. Thus, one way to view the debate is to observe that both supporters and opponents of efficient breach seem to agree that promise-breaking is morally wrong. They just disagree about the nature of the promises made in contracts.<sup>44</sup>

Regrettably, scholars have made relatively little effort to identify empirically the social meaning of contractual promises.<sup>45</sup> Instead they often rely on uncritical appeals to personal sensibilities and “normative” judgments. Courts, however, have by necessity wrestled for centuries with the empirical question of what parties mean by their contractual promises. Over the years, there have been exactly two sets of occasions in which courts are asked to determine whether the parties intended their contractual promise to mean merely “perform” or “perform or pay.” The first is when the contract stipulates deeds without mentioning payment in the case of nonperformance of those deeds. The second is when the contract stipulates deeds and explicitly calls for payment when the stipulated deeds are not performed. That is, courts have

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fact, courts can often observe (or speculate about) what the parties would have wanted had the ex ante transaction costs of contract specification not been prohibitive. Frank Easterbrook and Daniel Fischel use such a framework to explain a number of aspects of fiduciary, contract, and corporate law. See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993). Under this conception, the efficient breach hypothesis isn’t about breach at all; it is a gap-filling proposition that uses the hypothetical bargain to identify the payments that parties would have wanted (i.e., intended) to be associated with performance that does not conform to the extant agreement. This approach, of course, doesn’t deal with issues of noncontractibility (aspects of agreements that are impossible to verify ex post, making the hypothetical bargain inapplicable), but it is a useful approach in many cases.

44. Some opponents of efficient breach also argue that expectation damages tend to be undercompensatory. This argument (in addition to supporting efficiency claims against efficient breach) presents a moral claim that under an expectation damages regime, breaching is morally wrong because it allows the promisor to benefit at the expense of the promisee. See, e.g., Friedmann, *supra* note 6; Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982).
45. Noteworthy empirical research on the social meaning of contractual promises may nonetheless be found, even if it is rare. See, e.g., Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

long recognized that although the parties may stipulate a damage amount in the event of nonperformance, such a stipulation does not necessarily imply an intention to give the promisor an unfettered option to perform or pay. Indeed, the stipulation might imply just the opposite. By setting a stipulated damage amount so high that it has the practical effect of discouraging nonperformance, parties may convey their intent that nonperformance, while always a real option for the promisor, should not be construed as a permissive one. Penal bonds, which were regularly enforced from the medieval era through the late seventeenth century, were often used for this purpose.<sup>46</sup>

Even when a court was convinced that a bond was not being used to terrorize the promisor to perform, it did not automatically assume that the bond implied an intent to create an optional contract—one that explicitly permitted the promisor to fulfill her obligation by performance or by payment. Parties often stipulated payment for nonperformance through a separate bond (or within the contract) merely as a means of assuring that they received no less than actual damages in the event of breach.<sup>47</sup> Of course, parties did at times

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46. Parties exchanged bonds with large monetary payoffs that would become defeasible on performance of a party's promise, see THEODORE SEDGWICK, A TREATISE ON THE MEASURE OF DAMAGES; OR, AN INQUIRY INTO THE PRINCIPLES WHICH GOVERN THE AMOUNT OF COMPENSATION RECOVERED IN SUITS AT LAW 392 (N.Y., John S. Voorhies 2d ed. 1852), or void following an express condition subsequent (i.e., performance), see Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428, 1440 (2004).
47. Whether parties employing penal bonds as such actually intended this outcome or whether it was a fiction of the courts remains unclear. In any event, it allowed the court to pursue what it believed to be the parties' intent, while rejecting excessive penalties. When a promisor failed to perform, the promisee would be entitled to actual damages paid out of the bond, and any remaining balance on the bond would be returned to the promisor. For example, in *Sloman v. Walter*, (1783) 28 Eng. Rep. 1213, 1214 (Ch.), the Chancellor confirmed that when a penal bond was used to secure the enjoyment of a separate objective, the separate objective was "considered as the principal intent of the deed." The bond's purpose was to "secure the damage really incurred," and therefore the defendant did not need to pay the penalty, but only actual damages. *Id.* What happened when actual damages were greater than the amount of the bond? Courts were divided on this question: some treated the bond as setting the maximum recovery, see, e.g., *Wilbeam v. Ashton*, (1807) 170 Eng. Rep. 883 (K.B.); *Stewart v. Rumball*, (1705) 23 Eng. Rep. 926 (Ch.); *Hale v. Thomas*, (1685) 23 Eng. Rep. 515 (Ch.), while others provided for full recovery of actual damages even if it exceeded the bond amount, see, e.g., *Chilliner v. Chilliner*, (1754) 28 Eng. Rep. 337 (Ch.); *Hobson v. Trevor*, (1723) 24 Eng. Rep. 695 (Ch.). Courts recognized that parties also sought to ensure that actual damages were not underestimated by enumerating payments in the event of nonperformance (essentially, what we now refer to as a liquidated damages clause). Although courts often viewed these clauses skeptically, fearing that they might be penalties in disguise, courts did not discourage their use, but rather relied on them more or less depending on whether actual damages were difficult or easy to determine. See SEDGWICK, *supra* note 46, at 400.

incorporate stipulated amounts in agreements to convey their intention to allow promisors to discharge their duties through payments. These so-called alternative or optional contracts explicitly provided that the promisor could fulfill her obligation by either performing specified deeds or paying specified amounts (at the promisor's election).<sup>48</sup> Yet the intentions behind these agreements were not self-disclosing, and courts struggled mightily over them.<sup>49</sup> If it is hard to figure out whether parties intend their contractual promises to be of the form "perform or pay" when their agreements expressly state amounts that should be paid in the event of nonperformance, then what can we conclude about the parties' intentions and the meanings of their promises when their agreements are silent on nonperformance contingencies?

This is the key empirical question. And to the extent that contract obligation derives from the intention (subjective or objective) of parties, an empirical answer is the only means of resolving the positive debate over the meaning of contractual promises.<sup>50</sup> We need not essentialize promises (as opposed to other means of giving rise to contractual obligation), but it would be surprising if, for most people, contractual promises do not share some of the moral imperative behind promises generally. This is not to say that the two relations are identical or that one is a subset of the other. The legal relation is not defined by the social one, but they are connected in the minds of most people, except perhaps for the Holmesian bad man (whose morals may be represented as the lowest common denominator for civic participation). All the same, while Holmes predicted a legal-moral disconnect for the bad man, leading to a "perform or pay" conception of contract duty, he himself rejected

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48. See, e.g., *Pearson v. Williams' Adm'rs*, 24 Wend. 244 (N.Y. Sup. Ct. 1840), *aff'd*, 26 Wend. 630 (N.Y. 1841); *Lowe v. Peers*, (1768) 98 Eng. Rep. 160 (K.B.).

49. See SEDGWICK, *supra* note 46, at 398 (quoting Lord Kaims's lament that courts frequently and incorrectly labeled alternative obligations as penalties).

50. There has been considerable research by economists on the optimal structure of stipulated damages. See, e.g., Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI.-KENT L. REV. 33 (2003); Goetz & Scott, *supra* note 27; Hermalin & Katz, *supra* note 43; Kathryn E. Spier & Michael D. Whinston, *On the Efficiency of Privately Stipulated Damages for Breach of Contract: Entry Barriers, Reliance, and Renegotiation*, 26 RAND J. ECON. 180 (1995). Recently, law and economics scholars have turned their gaze to the circumstances in which parties would explicitly contract for damages, the option to compel performance, or both. See, e.g., Ronen Avraham & Zhiyong Liu, *Incomplete Contracts with Asymmetric Information: Exclusive Versus Optional Remedies*, 8 AM. L. & ECON. REV. (forthcoming 2006); Steven Shavell, *Specific Performance Versus Damages for Breach of Contract: An Economic Analysis*, 84 TEX. L. REV. 831 (2006); Richard R.W. Brooks, *Simple Rules for Simple Courts* (Mar. 2005) (unpublished manuscript, on file with author). In contrast to the present Essay, this line of research focuses on the optimal design and implementation of remedial options, rather than on what may be inferred about the nature of contractual rights given these options.

this morally permissive understanding.<sup>51</sup> In the end, perhaps the only difference between Holmes and the critics of his option theory of contract was that he predicted that the social meaning of contract promises would prove to be close to the views held by the bad man, while his challengers predicted that it would be closer to Holmes's personal views. These predictions still await (dis)confirmation.

### B. Normative Clarity

"Breach of a legal contract without excuse is *wrong* conduct."<sup>52</sup> No one can doubt this. When contractual parties explicitly promise to "perform deeds" as opposed to "perform deeds or pay money," the fact that they knowingly face the legal consequence of "pay money" for breach in the former case does not create an equivalence between it and the latter case.<sup>53</sup> Posner is correct to observe that on some level (say, economic) the promises generate the same "practical effect,"<sup>54</sup> but they do not have the same legal and moral effect. To miss this point is to obscure the difference between a price and a fine—a sanction. Prices and sanctions are not the same: prices permit "acts that leave the individual discretion to make choices. In contrast, law sanctions forbidden

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51. "I don't think a man promises to pay damages in contract any more than in tort. He commits an act that makes him liable for them if a certain event does not come to pass, just as his act in tort makes him liable *simpliciter*." Letter from Oliver Wendell Holmes to Frederick Pollock (Dec. 11, 1928), in 2 HOLMES-POLLOCK LETTERS 233, 233 (Mark DeWolfe Howe ed., 1941).
52. *Bailey v. Alabama*, 219 U.S. 219, 247 (1911) (Holmes, J., dissenting) (emphasis added).
53. Legal rules often simultaneously provide guidance to individuals subject to the rules and to officials charged with enforcing these rules. For instance, a rule of contract enforcement may direct promisors to perform their promises, while at the same time directing judges to compel payment of compensation when promises are not performed. Meir Dan-Cohen refers to the latter, the directive addressed to judges and other officials, as a "decision rule" and to the former, the directive addressed to promisors, as a "conduct rule." Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625, 627 (1984). In the world of full acoustic separation imagined by Dan-Cohen, where judges and promisors heard only their own directives, promisors would understand their duty to keep their promises as something distinct from an option to either perform or face judicial sanctions. But, alas, we do not live in a world where "law's attempt to segregate its normative messages through acoustic separation," *id.* at 636, can be fully realized. From this perspective, it is easy to see how scholars such as Jeremy Bentham, Hans Kelsen, and Richard Posner might distort a legal duty to perform contractual promises into a duty to "perform or pay."
54. See POSNER, *supra* note 9, at 58.



acts that involve social judgments.”<sup>55</sup> That this difference may be lost on the bad man (or, to use the contemporary euphemism, the “sophisticated party”) does not in itself delimit the legal and social meanings of contract promises. It is here that efficient breach arguments become problematic by suggesting a legal theory of contract—as opposed to a purely economic one—while refusing to acknowledge that sanctions have legal and social meaning beyond their nominal translation into prices.<sup>56</sup> But economic efficiency doesn’t compel this limited view of legal obligation. The efficient performance hypothesis implicitly establishes this point, which I shall now make explicit.

To demonstrate the point, recall the triple  $\{e, d, m\}$ , in which  $e$  represents an entitlement holder,  $d$  denotes who has the legal right to allocate the entitlement, and  $m$  is the measure of damages paid to the entitlement holder when the entitlement is allocated away from her. It is tempting to see the efficient performance hypothesis’s use of disgorgement ( $m$ ) as a source of moral superiority to efficient breach. After all, disgorgement deprives promisors of the “unjust” gains of their wrongful conduct, a deprivation that may also have the beneficial secondary effect of discouraging the conduct in the first place. This view, however, is not sustainable. First, wrongful nonperformance by the promisor does not imply that the subsequent gains from such conduct are unjust. A promisor’s efforts to create more efficient opportunities may justify her participation in some or all of the gains of these opportunities, despite the wrongful action taken to bring them to fruition.<sup>57</sup> Furthermore, even if it would be unjust for the gains to go to the promisor, it is not clear that it would be any more just for them to go to the promisee.<sup>58</sup> One might, of course, view the normative justification of disgorgement not in terms

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55. Robert Cooter, *Models of Morality in Law and Economics: Self-Control and Self-Improvement for the “Bad Man” of Holmes*, 78 B.U. L. REV. 903, 915 (1998); see also Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984); Dan-Cohen, *supra* note 53, at 627 (observing “the difference between a fine and a tax”).

56. One might argue that it is not necessarily improper for economics to fail to draw a distinction between prices and sanctions (and note that Holmes’s bad man embodies the ethics of the neoclassical self-interested rational economic actor), but for American contract law the difference is nontrivial. Yet, there is also a growing empirical literature among economists showing that economic actors do distinguish between prices and sanctions. See Samuel Bowles, *Mandeville’s Mistake: Are Good Laws a Substitute for Good Citizens?* (Oct. 19, 2006) (unpublished manuscript, on file with author).

57. See *Boardman v. Phipps*, [1967] 2 A.C. 46 (H.L.) (appeal taken from Eng.); see also discussion *supra* note 40.

58. “The taint that attaches to the promisor’s gain by the wrongful manner of its acquisition does not in itself make the promisee rather than someone else the justified recipient of that gain.” Weinrib, *supra* note 36, at 74. What is missing here, as Ernest Weinrib observes, is “the normative connection between the gain and the promisee’s entitlement to it.” *Id.*

of deservingness, but as a means of deterring the wrongful conduct itself—a prophylaxis—making use, to paraphrase Fuller and Perdue, of “[w]hatever tends to discourage breach of contract.”<sup>59</sup> But this view would also recommend specific performance, prison, and other penalties for breach. Distinctions among these remedies may be drawn, but this is unnecessary for present purposes because the moral force of the efficient performance hypothesis derives not from the damage measure it employs, but from its assignment and treatment of rights.

When one promises in contract to perform *X*, the promise creates an entitlement (*e*) for the promisee. But what is the nature of that entitlement: exactly what has the promisee acquired from the promisor? I believe it mistaken to argue that the promisee acquires a right to the subject matter of the promise—a right to possess *X*. Nor is it sufficient to say that the promisee acquires a right to be placed in the same position she would enjoy from possessing *X*—i.e., to be provided with a comparable utility level  $U(X)$ .<sup>60</sup> Rather, by promising in contract, the promisor relinquishes her legal right to choose whether to perform the promised deed. Moreover, according to some moral philosophies, this right is in large part conveyed to the promisee. Immanuel Kant, for instance, argued that the promisee acquires possession of “another’s choice to perform a specific deed (*praestatio*).”<sup>61</sup> That *d* is assigned to the promisee is an essential fact of contract under this Kantian view. But it is not just this particular view of contract that assigns *d* to the promisee. Contemporary philosophers, such as David Owens, also embrace the view that the promisee acquires the right to compel or release the promisor’s performance.<sup>62</sup> The promisor retains the power over the choice to perform the promised deed, but not the right.<sup>63</sup> The efficient breach hypothesis is inattentive to this key distinction, while the efficient performance hypothesis is premised on it.

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59. Fuller & Perdue, *supra* note 19, at 61 (observing another remedy’s “purpose being not so much to compensate the promisee as to penalize breach of promise by the promisor”).

60. *U* denotes the utility function of the promisee and  $U(X)$  her level of enjoyment from *X*.

61. KANT, *supra* note 42, at 6:247.

62. See Owens, *supra* note 42. As Jules Coleman suggests, the promisee acquiring this discretion is fundamental to the classical liberal conception of rights. JULES COLEMAN, *RISKS AND WRONGS* 336 (1992) (“How can a liability rule . . . protect my right when it gives you and others certain important discretions with respect to the uses to which my right can be put . . . ?”).

63. The promisor retains actual power, or what Wesley Hohfeld called physical power, as opposed to what he defined as legal power, the power to effect a change in legal relations. Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 *YALE L.J.* 16, 44, 52 (1913).

All morally informed views of contract obligation understand the promisor as constrained by the promise (hence the obligation). Conceptions of contract with ethical views stronger than the efficient breach's "intermediate level of moral force" typically require that the legal right to choose whether to perform (*d*) is not assigned to the promisor. Yet this does not imply that *d* must therefore be assigned to the promisee, as the efficient performance hypothesis dictates. The claim here is not, however, that the efficient performance hypothesis is consistent with all, or even most, moral understandings of contract promises, just with some. Still, the logic behind the efficient performance hypothesis does suggest that one might devise even more nuanced approaches to the assignment of *d*—involving, for instance, state-contingent or fractionated assignments<sup>64</sup>—that could suit other moral formulations of contract promises while achieving efficiency. I will say a little more about this in the Conclusion.

Let us now turn to the third and final aspect of the claim that efficiency allows for competing notions of contractual obligation. Having argued that both *e* and *d* rest with the promisee under some, perhaps most, moral frameworks of contract enforcement, I must now show that the damage measure (*m*) employed by the alternative hypothesis is consistent with such frameworks. Let's continue to focus on the Kantian conception of contract entitlement as described above. Kant doesn't tell us which damage measure should be used for breach of contract, but according to Ernest Weinrib, the "Kantian account of contractual entitlement provides a basis for the expectation measure of damages."<sup>65</sup> I remain unconvinced that there are particularly strong grounds for this conclusion<sup>66</sup> but take the claim as given. Under the modified disgorgement remedy described earlier, any transfer from the promisee's disgorgement remedy to the promisor that leaves the promisee with at least her expectation (plus  $\epsilon > 0$ , as  $\epsilon \rightarrow 0$ ) will preserve the efficiency of her allocative decision. This means that the alternative hypothesis can be implemented with essentially the expectation remedy (if one believes that this remedy is required under the Kantian framework) without changing its basic conclusion. Indeed,

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64. The promisor's obligations may also be validly excused by the realization of certain conditions (i.e., *d* may be assigned to the promisor in some circumstances), or the promisor's right to demand performance or compensation may be triggered by the occurrence of certain events (so that *d* is assigned to the promisee in some circumstances), or a third party, such as the court, may possess the legal right to choose.

65. Weinrib, *supra* note 36, at 68.

66. It seems that this basis is really more of a convenience, "merely a way of measuring the value of the promise itself." *Id.*

any damage amount between expectation and disgorgement will suffice, regardless of which is greater.<sup>67</sup>

## CONCLUSION

There are a number of reasons why promises give rise to legal and moral obligations. Reliance on promises by others is a familiar justification in law and in philosophy for the obligation to keep one's promises.<sup>68</sup> Social practices also clearly provide moral force to promises; promise-keeping, observed David Hume, is an "artificial virtue"—*artificial*, in contrast to *natural*, but nonetheless a *real* moral virtue.<sup>69</sup> Yet breaking promises (in contracts or otherwise) need not be immoral. That determination depends upon expectations and established conventions involving promises.

For some time now, there has been a sustained effort in American contract law to dissociate general moral obligations to keep promises from the conventions of contract obligation and the practices of legal enforcement. Beginning with Holmes and others in the late 1800s and intensifying in the law and economics scholarship of the past quarter-century, some jurists and scholars have argued for an approach to contract enforcement that would render breach legally and morally uncontestable, assuming compensation follows. Much of the justification for this conceptual endeavor has rested upon claims of judicial and economic efficiency.<sup>70</sup> But efficiency neither favors nor disfavors their conception of contract, formalized

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67. As suggested earlier, transfers from the promisor to the promisee may also be made under the efficient breach hypothesis to, in effect, replicate the disgorgement remedy without sacrificing the allocative efficiency of the traditional approach. The nominal damage remedies operate here merely as prices, guiding behavior toward efficiency without any particular ethical import. Yet lump-sum transfers may be used, as suggested by the Second Theorem of Welfare Economics, to pursue ethical aims of compensation and distribution while achieving an efficient allocation of resources. This simply reinforces the claim that it is not a difference in remedies that distinguishes efficient breach from efficient performance. The key difference is the fundamental understanding of legal rights—what Coleman calls the semantic content of rights. COLEMAN, *supra* note 62, at 335-40.
68. Scanlon, for instance, explains the moral obligation to keep promises "in terms of general principles arising from the interests that others have in being able to rely on expectations about what we are going to do." T.M. Scanlon, *Thickness and Theory*, 100 J. PHIL. 275, 283 (2003).
69. HUME, *supra* note 2, at 518-19 ("[P]romises have no force, antecedent to human conventions.").
70. Limited empirical work on the matter suggests that this conceptualization has had practically no impact on judicial practice. See Craig S. Warkol, Note, *Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach*, 20 CARDOZO L. REV. 321 (1998).

by the efficient breach hypothesis. I have claimed in this Essay that amorality or, more accurately, the particular form of morality employed by the efficient breach hypothesis, is not required for efficiency. To demonstrate this claim, the Essay developed an alternative approach to contract enforcement—expressed as the efficient performance hypothesis—based on a stronger notion of promissory obligation than that associated with efficient breach; it showed the alternative and traditional hypotheses to be equally efficient.

The efficiency equivalence between these hypotheses may have been predicted from the First Theorem of Welfare Economics.<sup>71</sup> This theorem can be summarized in two parts: first, with appropriate prices, a competitive market will lead to efficient allocation of resources; second, a competitive market process will generate appropriate prices.<sup>72</sup> Similarly, both the efficient breach and efficient performance hypotheses will lead to efficient allocation of resources when damages for breach are appropriately chosen. But, of course, it is an evidentiary process—not a competitive one—that brings about the appropriate “prices” in this context. Thus, one might prefer efficient breach or efficient performance if there is reason to believe that the evidentiary process (or judicial efficacy) supports one hypothesis over the other. I have suggested that, a priori, there is no good reason for such a belief.

Yet if, a priori, these hypotheses are indistinguishable in terms of efficiency, they are certainly not equivalent in terms of their conception of promissory obligation. And, importantly, it is not the “price” of breach (i.e., nominal disgorgement or expectation damages) that matters ethically; it is the nature of the rights that attach to promissory obligation. The efficient breach hypothesis supposes that the promisor has the legal right—not merely the de facto power—to choose to perform or pay damages. That right belongs to the promisee under the efficient performance hypothesis. Moreover the discrete ethical conceptions represented in the efficient breach and efficient performance hypotheses do not exhaust the possibilities. These hypotheses taken together, in fact, suggest that other conceptions of moral obligation may be infused in efficient enforcement mechanisms if sufficient attention is paid to “prices.” Of course, not every ethical conception of promissory obligation can be made to fit within an efficiency framework, but the possibilities are significantly greater than the efficient breach hypothesis would suggest.

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71. The economic outcomes, of course, will not necessarily be equivalent given different endowments of rights and resources.

72. Economists broadly regard proof of this theorem as a formal demonstration of Adam Smith’s claim that economic exchange will lead self-interested individuals, like an “invisible hand,” to promote the public benefit.