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## Remedies On and Off Contract

**ABSTRACT.** Liberal allowance of rescission followed by restitution has, for centuries, unsettled legal authorities who fear it as a threat to commercial order or other normative values. Responding to these fears, authorities have limited the ease with which rescission may be elected. Their responses, however, are often excessive and based on misunderstandings of the remedy's effects. Rescission, followed by restitution, may in fact promote contracting by allowing parties to create efficient incentives. Concern about the stability of contracting is not entirely unfounded, but the problem is not primarily due to the ease of rescission following breach; rather, the problem concerns the remedy that follows rescission. This Article presents an argument for liberal rescission followed by limited ensuing remedies. Modern reforms and proposals seem to embrace the opposite route, restricting access to rescission while, at times, allowing for generous ensuing remedies. These reforms and proposals, we show, are the real threat to contractual stability.

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**INTRODUCTION**

Not every wrong has a remedy, and some wrongs—like ordinary breach of contract, the subject of this Article—would appear to have very many remedies. Expectation damages, the common law default, are nowhere near an exclusive remedy for breach. Reliance, restoration, disgorgement, and specific performance are just some of the more familiar forms of relief available to disappointed promisees. Yet whether, and to what extent, promisees (or even courts) may choose among these conventional alternatives, as opposed to having the legally apposite remedy dictated to them by extant circumstances, are contested and unsettled questions. One remedial election, however, is unquestioned by observers. Aggrieved parties in appropriate circumstances may (1) “affirm” their contracts and seek money damages or specific performance on the contract or (2) “disaffirm” their contracts with the off-contract remedy of rescission followed by restitution. This fundamental choice, long part of the common law tradition, is doctrinal orthodoxy.

In the prototypical case, a buyer pays up-front for goods that are never delivered. Near-universal consensus holds that the buyer may elect to affirm the contract and receive an on-contract remedy or disaffirm the contract, which rescinds or, more sensationally, “annihilates the contract,” after which the court “puts the parties in the same position as if [the contract] had never existed.”<sup>1</sup> To put the parties in the same position as if the contract had never existed, the so-called *status quo ante*, it is necessary to restore the payment to the buyer; this restoration is achieved through an action in restitution.<sup>2</sup> Had

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1. *Ballou v. Billings*, 136 Mass. 307, 309 (1884) (Holmes, J.). There are disagreements about the details and motivation behind the election, but there is a broadly shared view on the right to elect. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 37 (Tentative Draft No. 3, 2004); RESTATEMENT (SECOND) OF CONTRACTS § 373 & cmt. a (1981).
  2. Rescission undoes the agreement, eliminating all obligations under the contract from the time of breach going forward and backward (*ex tunc* or *ab initio* effect). When obligations are eliminated only going forward from the time of breach (*ex nunc* effect), avoidance, termination, and cancellation are often usefully invoked as distinct remedies. See, e.g., United Nations Convention on Contracts for the International Sale of Goods, art. 81, Apr. 11, 1980, 1489 U.N.T.S. 3 [hereinafter CISG]. Regrettably, these distinctions are sometimes conflated, leading to some confusion in the law and in legal literature. The comment to section 2-608 of the Uniform Commercial Code (UCC) (“Revocation of Acceptance in Whole or in Part”) makes it clear that the term “rescission” was avoided in the Code because of concern that the term was “capable of ambiguous application . . . and susceptible also of confusion with cancellation.” U.C.C. § 2-608 cmt. 1 (2003). Confusion remained nonetheless. See *Welken v. Conley*, 252 N.W.2d 311, 315 (N.D. 1977). This is due in part to the Code itself sometimes using the term “rescission” and nowhere defining what it means

the seller delivered goods that did not conform to the contract, so delivery was nonetheless a breach, then restitution to the seller *in specie* or in an amount equivalent to the reasonable value of the seller's nonconforming performance would apply as well.<sup>3</sup> As this last example reveals, the right to elect rescission and restitution is not limited to the prototypical case in which the breaching party wholly fails to perform.

Any breach of a sufficient degree by one party is enough to trigger the other's right to disaffirm the contract. No one disputes this basic proposition, but controversy has always surrounded the matter of what exactly counts as sufficient. For centuries, too low a threshold, which would allow easy availability of rescission followed by restitution, has been a source of great anxiety among legal authorities, who see it as a threat to commercial order and other normative values. Responding to these fears, authorities have limited the ease with which rescission may be elected. Their approach is often excessive and based on misunderstandings of the remedy's effects. Taking the economic effects of the remedy as a basis for its argument, this Article makes a case for a more liberal right of rescission followed by restitution.

The argument is relatively straightforward. First, foreseeing the possibility of rescission by counterparties, promisors will invest to enhance the quality of performance, thereby reducing the likelihood that the rescission right is triggered. Second, promisors can also make rescission less desirable for counterparties by reducing the price that they charge, implying a lower, less attractive remedy in restitution. Through its effect on quality and price, the option to rescind followed by restitution may be enlisted by parties to promote efficient contracting. The old concern about the stability of contracting, it must be conceded, is not entirely unfounded, but the problem is not primarily due to the ease with which parties are able to rescind following breach; rather, the problem lies with the remedy that follows rescission. Hence, the final point of our argument: the remedy in restitution following rescission should be limited to restoration of price or other conferred benefits to the promisor under the contract.

These points are elaborated in detail in the latter Parts of the Article, but first we provide more background and an intuitive sketch of the argument in

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by that usage or explaining if it differs in application from "revocation of acceptance." For a discussion of the different legal effects of rescission, see, for example, 2 ERNST RABEL, *DAS RECHT DES WARENKAUFS: EINE RECHTSVERGLEICHENDE DARSTELLUNG* § 106(1) (1958); and Janet O'Sullivan, *Rescission as a Self-Help Remedy: A Critical Analysis*, 59 *CAMBRIDGE L.J.* 509 (2000).

3. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 36 (Tentative Draft No. 3, 2004).

Part I. The next task, a central one to the argument, is to address the role played by product quality in contract remedies. We briefly discuss how quality entered into contract law in Section II.A. We then show, in Section II.B, that integrating quality as a baseline for calculating expectation damages provides incentives for sellers to invest in the quality of their products. Section II.C goes on to demonstrate that the possibility of going off the contract facilitates the task of providing efficient incentives for investments in product quality.<sup>4</sup> Moreover, the availability of rescission followed by restitution can lead to redistribution from the seller to the buyer, which may have positive welfare effects when the seller has monopoly power.<sup>5</sup> We conclude Part II by considering suboptimal trade decisions, where promisees inefficiently return goods, and wasteful strategic expenditures as a consequence of the availability of rescission.<sup>6</sup> Part III addresses some implications of our findings for modern reforms and reform proposals, which appear to take the exact opposite of this Article's stance in favor of liberal rescission rights followed by limited remedies. Reformers seem to embrace restricting access to rescission, while at times allowing for generous ensuing remedies. We show that it is this position, ironically, that poses the real threat to contractual stability.

## I. BACKGROUND AND SKETCH OF ARGUMENT

Availing the right to rescind and recover price was a common occurrence in the historic markets of Rome. As market magistrates, the *curule aediles* allowed the victim of nonconforming performance to choose freely between *actio redhibitoria* (rescission and restitution) and *actio quanti minoris* (acceptance and apportionment).<sup>7</sup> From this liberal beginning, the impulse of subsequent legal

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4. See *infra* Subsection II.C.1.

5. See *infra* Subsection II.C.2.

6. See *infra* Subsection II.C.3.

7. See 2 CHARLES PHINEAS SHERMAN, ROMAN LAW IN THE MODERN WORLD: MANUAL OF ROMAN LAW ILLUSTRATED BY ANGLO-AMERICAN LAW AND THE MODERN CODES § 790 (3d ed. 1937); REINHARD ZIMMERMANN, THE LAW OF OBLIGATIONS: ROMAN FOUNDATIONS OF THE CIVILIAN TRADITION 311-37 (1990). The *actio redhibitoria* was introduced in the early part of the second century BC. ZIMMERMANN, *supra*, at 311 n.113. The *actio quanti minoris* may have been introduced later but was no doubt available in early classical law. *Id.* at 318. In the course of time both actions became known as “the” aedilitian remedies and were routinely available. See *id.* at 325. By restitution, in this reference, we mean restoration of price. By apportionment we mean price reduction in some proportion to the value of what was received by the injured party. Price could be reduced in at least three ways: first, one might simply pay a price equivalent to the lower value of what was received (*quantum meruit* or *quantum valebant*); second, the price might be reduced by the shortfall between value

convention, against which this Article provides analytical counterweight, has been to limit the ease with which rescission may be elected. Early civil law jurisprudence, influenced by medieval moral theology,<sup>8</sup> restricted the right of rescission to cases where the defect in the seller's performance, had it been known to the buyer at the time of contracting, would have led the buyer to abstain from entering into the contract in the first place.<sup>9</sup> Common law's developed practice also hewed tightly to stringent requirements before granting promisees the right to elect rescission, particularly in English courts. American courts were exceptional, as Samuel Williston observed: "In the United States the law is more liberal."<sup>10</sup> That was his view of late nineteenth-century U.S. courts, and since then the doctrine has only become more liberal.

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expected and received, which amounts to diminution in value with an upper limit set by price; third, the ratio of value received and expected could be used to multiply (that is, deflate) price accordingly. See RABEL, *supra* note 2, § 99(1)(a). In practice, it has been suggested that price reduction leads to roughly the same result as expectation damages for partial breach. See JAN KROPHOLLER, *STUDIENKOMMENTAR BGB* § 281, ¶ 5 (9th ed. 2006) (citing the official explanations of the German government bill on the reform of the law of obligations, DEUTSCHER BUNDESTAG: DRUCKSACHEN UND PROTOKOLLE [BT] 14/6040, at 226 (Ger.)).

8. See Martin Schermaier, *New Law Based on Old Rules: Antecedents and Paragons of the Modern Law on Producers' Liability*, in *EUROPEAN PERSPECTIVES ON PRODUCERS' LIABILITY: DIRECT PRODUCERS' LIABILITY FOR NON-CONFORMITY AND THE SELLERS' RIGHT OF REDRESS* 77, 80-81 (Martin Ebers, André Janssen & Olaf Meyer eds., 2009).
9. See 2 HUGO GROTIUS, *DE JURE BELLI AC PACIS LIBRI TRES* bk. 2, ch. 12, § VIII, at 346-47 (James Brown Scott ed., Francis W. Kelsey et al. trans., William S. Hein & Co. 1995) (1646). For an account of the influence of natural law ideas on the development of warranty law, see WALTER-JÜRGEN KLEMP, *DIE GRUNDLAGEN DER SACHMÄNGELHAFTUNG DES VERKÄUFERS IM VERNUNFTRECHT UND USUS MODERNUS* 22 (1967).
10. Samuel Williston, *Repudiation of Contracts*, 14 *HARV. L. REV.* 317, 326 (1901). There were two strong conditions in the English common law for contract rescission, both of which were substantially weakened in America. First, the promisor's breach had to be on the order of a repudiation or abandonment of the contract, which supported the fiction that repudiation or abandonment was actually an offer by the promisor to rescind the contract, allowing the other party to accept by rescinding, too, and thereby establishing a mutuality of rescission. American courts relied little on this fiction. It "must be regarded as erroneous in principle and unfortunate in practice," argued Williston. *Id.* at 324. He further stated:

In truth rescission is imposed *in invitum* [against the will of the other party] by the law at the option of the injured party, and it should be, and in general is, allowed not only for repudiation or total inability, but also for any breach of contract of so material and substantial a nature as should constitute a defence to an action brought by the party in default for a refusal to proceed with the contract.

*Id.* at 325. In other words, breaches that would allow an injured party to terminate and seek damages would also give rise to a right to rescind. Second, promisees could not ordinarily elect rescission "unless both parties [could] be reinstated in their original situation in respect

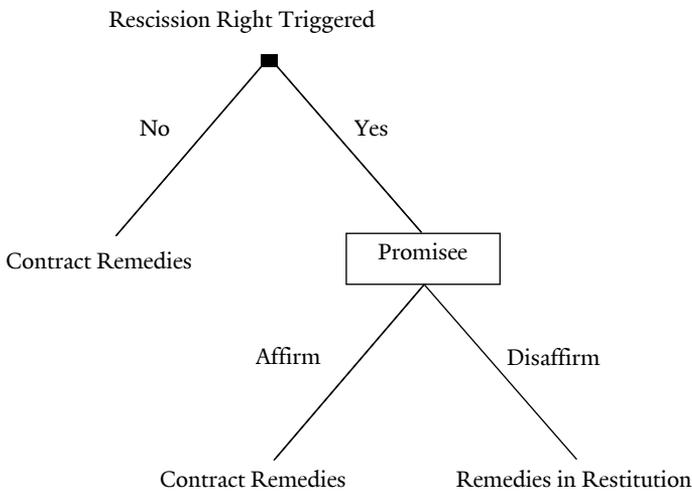
Too liberal, some argue.<sup>11</sup> Although not as permissive as the aediles, American courts have substantially weakened the old common law requirements for the right to elect rescission followed by restitution. Any nonconforming performance that amounts to a material breach triggers the right to elect between affirming and disaffirming the contract.<sup>12</sup> Figure 1 depicts the basic remedial regime following breach: on the one hand, when breach is not material, the right to rescind is not triggered and the promisee must find relief, if any is to be forthcoming, among conventional contract remedies like expectation damages, specific performance, and so on. On the other hand, when breach is material, rescission rights are triggered, giving the promisee a choice between (1) affirming the contract and looking to conventional contract remedies or (2) disaffirming and finding relief in the law of restitution.

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of the contract.” 2 WILLIAM W. STORY, A TREATISE ON THE LAW OF CONTRACTS § 977 (Lawbook Exch. 2006) (4th ed. 1856); see also Williston, *supra*, at 326 (“It is universally agreed that rescission is not allowable unless the party seeking to rescind can and does first restore or offer to restore anything he has received under the contract . . .”). While English courts demanded stern adherence to literal restitution, American courts have long been willing to devise judicially determined monetary estimates of the parties’ restitution interests.

11. Critics of the modern American doctrine, like Professor Andrew Kull, worry that it undermines the stability of contracts, claiming that “an unlimited right of rescission—a free choice between enforcement and avoidance as a remedy for any material breach, as proposed by the *Restatement*—is not a rule that contracting parties would either choose or recognize.” Andrew Kull, *Restitution as a Remedy for Breach of Contract*, 67 S. CAL. L. REV. 1465, 1517 (1994) (referencing RESTATEMENT (SECOND) OF CONTRACTS (1981)).
12. See RESTATEMENT (SECOND) OF CONTRACTS § 373(1) (1981) (characterizing the right to elect rescission followed by restitution as being triggered “on a breach by non-performance that gives rise to a claim for damages for total breach or on a repudiation”).

Figure 1.  
DICHOTOMY BETWEEN AFFIRMING AND DISAFFIRMING



Restitution steps in as the new legal basis for the promisor’s obligation to provide relief as soon as the prior contractual obligation is disaffirmed. Students often gloss over this subtlety—mistakenly conceiving restitution as simply a contract remedy—but they can hardly be faulted for the oversight. Much of the confusion about rescission and restitution endures because contract law scholars have lost sight of the old and customary distinction between actions taken on and off the contract. Blurring the doctrinal distinction was no accident,<sup>13</sup> nor is the effect merely incidental or academic. The practical and theoretical implications are of great consequence. An option to pursue an off-contract remedy is immensely valuable in everyday legal practice; it is often an expedient bypass to the high costs of proving damages or enforcing specific performance on the contract.<sup>14</sup> The differences between

13. Andrew Kull provides a compelling account of “How the Law Was Forgotten.” Andrew Kull, *Rescission and Restitution*, 61 *BUS. LAW.* 569, 581 (2006) (describing the decision by Arthur Corbin, reporter for the *Restatement of Contracts*, to eliminate the term “rescission” from that text, a decision affirmed by Allan Farnsworth, reporter for the *Restatement (Second) of Contracts*). The UCC has also contributed to the concealment of rescission through the murky label “revocation of acceptance.” U.C.C. § 2-608 (2003). *But see id.* § 2-720 (describing the effect of “cancellation” or “rescission”).

14. See DOUGLAS LAYCOCK, *MODERN AMERICAN REMEDIES: CASES AND MATERIALS* 624 (3d ed. 2002) (“[A p]laintiff may seek rescission because of its simplicity (no need to litigate the value of anything), or because of personal preferences not reflected in market values [where

actions on and off the contract are also theoretically compelling, though academics presently appear largely uninterested.

Theorists tend to dismiss the important potential of disaffirming a contract, relegating its salience to practical convenience in the context of perverse cases.<sup>15</sup> Why, they ask, but for the costs of enforcement on the contract, would an injured party ever choose off-contract restoration of price instead of seeking expectation damages on the contract? Expectation damages, after all, give the promisee the “benefit of the bargain”—the value that would have been realized had breach not occurred, which is ordinarily greater than the contract price.<sup>16</sup> Only in those odd cases where realized value of performance is less than price—that is, in losing contracts—is the option to rescind and pursue restitution preferable to expectation damages. In these cases it is certainly convenient for the promisee to disaffirm the contract and get his money back when the promisor happens to have breached. But would the parties, when entering into the contract, ever agree to give the promisee such a fortuitous option? Not likely, says Andrew Kull, reporter for the *Restatement (Third) of Restitution*: “[R]ational parties would not bargain” for such a right,<sup>17</sup> and “[i]f the enforcement [of on-contract] remedies were fully effective and costless, rescission would not exist as a remedy for default.”<sup>18</sup> That conclusion is too hasty.

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market value often determines expectation damages in practice], . . . or because she has lost confidence in [the] defendant and the transaction.”).

15. See Kull, *supra* note 11, at 1469 (“[R]estitution as an alternative remedy for breach of contract becomes interesting chiefly in cases where the aggrieved party has made an unfavorable bargain, a contract that he has been performing (or would have been obliged to complete) at a loss.”).
16. Expectation damages,  $v$ , also ordinarily exceed reliance damages, which include the price,  $p$ , and any incidental reliance,  $r_b$ , made by the buyer on the contract. Hence the familiar chain of inequalities, that ex ante expectation is greater than reliance, which in turn is greater than restitution of benefits conferred to the breaching party:  $v > p + r_b > p$ . Note that if the price has not been paid up-front this inequality would turn into  $v - p > r_b > 0$ . See RESTATEMENT (SECOND) OF CONTRACTS § 344 & cmt. a (1981).
17. Kull, *supra* note 11, at 1477.
18. *Id.* at 1499. Similarly, Mark P. Gergen sees the role of self-help remedies like “the power to refuse non-conforming performance” as helping breached-against parties “to avoid suffering a loss that damages may not adequately compensate” and lowering the amount of litigation. Mark P. Gergen, *A Theory of Self-Help Remedies in Contract*, 89 B.U. L. REV. 1397, 1398-99 (2009).

Rational parties, we argue, would often desire a right of rescission followed by restitution even if damages were fully compensatory and costless to enforce.<sup>19</sup> The mere presence of a threat to rescind, even if not carried out, exerts an effect on the behavior of parties. Parties can enlist this effect to increase the value of contracting. To illustrate, consider the situation of a seller of goods who knows that the buyer has a right to rescind the contract if the goods are defective. Since rescission is generally disfavored by the seller, she will try to reduce its incidence.<sup>20</sup> The seller knows that rescission occurs only when the contract price is more than the goods' value, as measured by expectation damages.<sup>21</sup> That is, the buyer will want to rescind only when the contract is a losing one: when the value that the buyer derives from the goods is less than the price that he paid for them. Moreover, rescission is only available to the buyer if the goods are defective, that is, when the quality of the goods falls short of the quality level specified or implied in the contract. But the seller is not without some control over the quality of the goods that she produces and the price that she charges for them.<sup>22</sup> By lowering the price, the seller can reduce the likelihood that the buyer will want to rescind the contract, and by investing in the quality of the goods, the seller can reduce the probability that the buyer will have the legal right to do so.

Both an increased investment in quality and a lower price of goods can be socially desirable, especially in situations where the seller has considerable market power. The effect of rescission on quality investments may often be desired by rational parties as they strive to increase the value of their contracting relationship. Lower price, though not in the interest of the seller, might nevertheless be socially desirable because it increases trade volume by curbing the seller's possible monopoly power. Legal commentators who focus on the risk that goods are returned, although it would be socially desirable for them to stay in the hands of the buyer, ignore that the threat to rescind is to a large extent only an out-of-equilibrium threat. It is a familiar result from analyses of sequential games that threats of disfavored responses off the equilibrium path are often essential to encourage players to take actions that

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19. Moreover, even in cases where parties would not voluntarily bargain for such a regime, we show that the availability of rescission might still be socially desirable. *See infra* Subsection II.C.2.

20. Throughout this Article, we refer to sellers using feminine pronouns and buyers using masculine pronouns.

21. We assume that damages are fully compensatory and costless to enforce.

22. This is the case if the seller has some market power, which is very plausible in many markets where the seller has monopoly power with respect to her own (branded) product.

keep them on a desirable equilibrium path.<sup>23</sup> In other words, these commentators do not take into account the (potentially welfare-increasing) efforts of the seller to reduce the probability of rescission actually occurring.<sup>24</sup>

The fact that the alternative right to affirm or disaffirm following breach can increase the value of contractual exchange has, we speculate, contributed to the permanence and pervasiveness of the fundamental alternative to seek remedies on and off the contract, an alternative found in the ancient laws of Asia and Europe as well as in their modern successors.<sup>25</sup> Yet contemporary contract scholars, with a few notable exceptions,<sup>26</sup> have neglected this venerable doctrine, focusing instead on the existence and salience of alternative remedies on the contract.

Had contemporary commentators merely overlooked the traditional right to elect rescission followed by restitution, our Article might only be of academic interest. However, the failure to appreciate the benefit of the traditional election has encouraged, we fear, two disturbing modern trends.

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23. The equilibrium path denotes the sequence of decisions made by rational players in a game. A common criterion for such rational decisions in sequential strategic interactions (called subgame-perfect equilibrium) is that no player, taking the other player's decisions as given, could profit by making another decision (which is the definition of a Nash equilibrium). Moreover (and this is the refinement added by the concept of subgame-perfect equilibrium), no player can be fooled into reacting to incredible threats. This concept comes from R. Selten, *Reexamination of the Perfectness Concept for Equilibrium Points in Extensive Games*, 4 INT'L J. GAME THEORY 25 (1975), which builds off his original work, Reinhard Selten, *Spieltheoretische Behandlung eines Oligopolmodells mit Nachfrageträgheit*, 121 Z. GESAMTE STAATSWISSENSCHAFT 301 (1965) (Ger.).
  24. Kull recognizes an ex ante incentive effect but wrongly concludes that the effect can only lead to overinvestment on the part of the seller: "Such investments, being expenditures that produce no social benefit, are inefficient by definition." Kull, *supra* note 11, at 1506.
  25. See Schermaier, *supra* note 8, at 79-80.
  26. Although a foil for some of our claims, Andrew Kull deserves particular recognition for his thoughtful research on restitution. See, e.g., sources cited *supra* notes 11, 13; see also E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339 (1985) (arguing that the disgorgement principle should be extended to cover certain cases of breach of contract); Daniel Friedmann, *Restitution for Wrongs: The Measure of Recovery*, 79 TEX. L. REV. 1879 (2001) (proposing a framework enabling a court to decide whether a party in breach of contract should have to make full restitution if her gain exceeds the other party's loss); Joseph M. Perillo, *Restitution in a Contractual Context*, 73 COLUM. L. REV. 1208, 1209 (1973) (arguing that restitution should not be seen merely as a remedy in cases of quasi-contract—that is, in cases where there is no actual contract—but rather as a remedy that often operates in an explicitly contractual setting where ordinary contract enforcement is defeated because "an agreement is made but is too indefinite, a contract is made but is unenforceable because of the Statute of Frauds, a contract is made but further performance is excused because of frustration or impossibility, a contract is avoided for mistake, etc." (footnotes omitted)).

First, demand to restrict the availability of rescission is, again, in ascension.<sup>27</sup> Second, while allowing for the availability of rescission, a number of jurisdictions are moving toward combining it with expectation damages.<sup>28</sup> The

27. Restricting the availability of rescission was a tendency in the drafting of the CISG. See PETER SCHLECHTRIEM, *INTERNATIONALES UN-KAUFRECHT* 6, 135-37 (4th ed. 2007). For a call for a more restrictive practice in the United States, see Kull, *supra* note 11. The law already employs several techniques to restrict rescission rights. Most importantly, it may (1) require that nonconformity exceed a certain threshold level, see CISG, *supra* note 2, art. 49(1)(a); COMM'N ON EUROPEAN CONTRACT LAW, *PRINCIPLES OF EUROPEAN CONTRACT LAW*, art. 9:301 (Ole Lando & Hugh Beale eds., 2000) [hereinafter PECL]; (2) require inspection of the goods upon delivery, see CISG, *supra* note 2, art. 38; (3) cut off the buyer's right to rescind if he does not notify the seller after he knew or ought to have known of the nonconformity, see *id.* art. 49(2)(b); and (4) require the goods to be in a condition such that restitution is possible, see *id.* art. 82(1); *supra* note 10 (describing the old common law of England).
28. The United States allows for combined remedies. See U.C.C. § 2-608 cmt. 1 (2003) (“[T]he buyer is no longer required to elect between revocation of acceptance and recovery of damages for breach. Both are now available to him.”); U.C.C. § 2-711(2) (2003); LAYCOCK, *supra* note 14, at 638 (“With respect to contracts for the sale of goods, UCC § 2-721 provides that rescission does not bar recovery of damages; there is no exception for lost profits.”); 1 GEORGE E. PALMER, *THE LAW OF RESTITUTION* § 4.15 (1978); JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 15.7 (6th ed. 2009) (citing *Grandi v. LeSage*, 399 P.2d 285 (N.M. 1965); Robert J. Nordstrom, *Restitution on Default and Article Two of the Uniform Commercial Code*, 19 VAND. L. REV. 1143 (1966)); see also 1 PALMER, *supra*, § 3.9 (discussing how courts have split on whether to allow lost profits in rescission cases).

The trend may be observed internationally in the CISG, *supra* note 2, arts. 75-76; the drafts for a common European contract law, PECL, *supra* note 27, art. 9:305; and the revised Japanese civil code, MINPŌ [MINPŌ] [CIV. C.] art. 545, translated in *Civil Code (Part I, Part II, and Part III)*, JAPANESE L. TRANSLATION, <http://www.japaneselawtranslation.go.jp/law/detail/?ft=3&re=02&dn=1&x=64&y=28&bu=8&ky=&page=16> (last visited Oct. 21, 2010). The new German civil code also explicitly allows for rescission followed by expectation damages. See BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Nov. 26, 2001, BUNDESGESETZBLATT, Teil I [BGBl. I] 3138, § 325, translated in Geoffrey Thomas & Gerhard Danneman, *German Civil Code—Bürgerliches Gesetzbuch*, IUSCOMP, <http://www.iuscomp.org/gla/statutes/BGB.htm> (last visited Sept. 6, 2010). Arguably, however, this did not functionally change the regime as it was also possible under the old German civil code to ask for “expectation damages in lieu of performance,” which had the same effect as rescission followed by expectation. See BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, REICHSGESETZBLATT [RGL.] 243, § 280.

There is also another force that increases the cumulative availability of rescission and expectation damages. Historically, and in civil law jurisdictions, the possibility of expectation damages (contract damages) does not arise unless the seller is at fault. In the case of nonconforming delivery, expectation damages even required deceit (*dolus*) on the part of the seller. The aedilician remedies in contrast impose strict liability on the seller. Therefore, while the aedilician remedies are available in all cases of nonconforming delivery, the problem of cumulative availability of rescission and expectation damages only arises if the seller is at fault. However, there has been a tendency over time toward relaxing the fault

movement away from traditional “rescission and restitution” toward “rescission and expectation” is especially harmful, as it makes rescinding a dominant strategy whenever the buyer has the legal right to do so. As we will show, these trends are the real threats to the stability of contracting, and they also eliminate the positive effects, identified in this Article, that follow from liberal availability of rescission combined with the traditional remedy in restitution.

## II. QUALITY AND CONTRACT REMEDIES

### A. Origins

Early Roman, English, and Germanic law of sales, it is said, all took for granted the ancient command “caveat emptor”—let the buyer beware.<sup>29</sup> Contract assured no underlying quality. The buyer bought exactly what he saw.<sup>30</sup> Over time quality found its way into contract law, most notably and influentially through the jurisdiction of the *curule aediles*.<sup>31</sup> The aediles introduced special remedies for certain market sales that held sellers strictly liable for latent defects as detailed in the edicts of the aediles.<sup>32</sup> The scope of the

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requirement. As the fault requirement is relaxed, expectation damages become available in more cases, and it follows that there is a risk of cumulative liability in more cases. See, e.g., ZIMMERMANN, *supra* note 7, at 327-28, 335-36 (discussing the famous “Pothier” rule and the German doctrine of “positive malperformance”). This problem becomes especially salient if a right of rescission is allowed at common law where the seller is strictly liable under contract law. Presumably, this was why the Uniform Sales Act, the precursor to the UCC, declared rescission and expectation damages to be mutually exclusive. UNIF. SALES ACT § 69(2) (1908). It is one of many ironies in this area that the UCC would so expressly abandon the mutual exclusivity of these remedies.

29. ZIMMERMANN, *supra* note 7, at 306-08. But see Walton H. Hamilton, *The Ancient Maxim Caveat Emptor*, 40 YALE L.J. 1133, 1157 (1931) (arguing that caveat emptor “did not embody custom or maxim, rule or philosophy”).
30. See ZIMMERMANN, *supra* note 7, at 307 & n.89 (describing the proverbs “*Augen auf, Kauf ist Kauf*” (“keep your eyes open, bought is bought”); “let their eye be their chapman”; and “*qui n’ouvre pas yeux doit ouvrir la bourse*” (“he who doesn’t open his eyes shall open his purse”) (translations by authors)).
31. See *id.* at 311.
32. Only latent physical defects (*morbus* and *vitium*) and certain defects of character that impaired the “fitness for use” were covered by the aediles’ edict: “Proinde si quid tale fuerit vitii sive morbi, quod usum ministeriumque hominis impediatur, id dabit redhibitioni locum.” *Id.* at 312 n.121 (quoting DIG. 21.1.1.8 (Ulpian, Ad Edictum 1)). J.A.C. Thomas translated Ulpian’s edict as: “So if there be any defect or disease which impairs the usefulness and serviceability of the slave, that is a ground for rescission . . . .” 1 THE DIGEST OF JUSTINIAN 21.1.1.8 (Alan Watson ed., G.E.M. de Ste Croix et al. trans., 1998). The scope

aedilitian remedies was originally limited to the sale of slaves and certain animals.<sup>33</sup> By late antiquity, however, if not in the earlier classical period (as scholars now believe), Roman jurisprudence had begun to develop familiar principles of implied quality and generalized liability for latent defects, using the aedilitian remedies as a template.<sup>34</sup> The aedilitian template would travel beyond Rome through the *Corpus Iuris Civilis*,<sup>35</sup> providing a framework of quality assurances that was eventually incorporated into the codes of civil law countries and arguably the doctrines of their common law counterparts.<sup>36</sup>

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of the seller's warranty, however, could be extended by formal or informal declarations (*dicta promissave*). See ZIMMERMANN, *supra* note 7, at 315-16.

33. Originally only beasts of burden other than cattle (*iumenta*) were covered by the edict, but the seller's liability was later generalized to all herd animals (*pecus*). See ZIMMERMANN, *supra* note 7, at 318-19.
34. Roman jurists invoked the good-faith (*ex fide bona*) clause inherent in the *actio empti* (the praetorian action based on the sales contract) to argue that conventional terms in express warranties became implied terms even though they were not explicitly mentioned. *Id.* at 320-21. Until recently it was more or less generally accepted that classical Roman law never advanced beyond the narrow scope of the edict. Although slaves and cattle were economically important goods, "caveat emptor" was still thought to prevail to a large extent. *Id.* at 319-20. This is also reflected in Williston's words: "It was true in both the earlier and the later classical Roman law, however, that for mere breach of a contract in regard to the goods, the buyer had no right of rescission." SAMUEL WILLISTON, *THE LAW GOVERNING SALES OF GOODS AT COMMON LAW AND UNDER THE UNIFORM SALES ACT* § 609 (2d ed. 1924).
35. The *Corpus Iuris Civilis* was issued in three parts from the years AD 529 to 534. The first part, the *Codex Justinianus*, compiled all imperial constitutions from the time of Hadrian. The second part, the *Digests* or *Pandects*, compiled the writings of the great Roman jurists along with current edicts. The third part, the *Institutiones*, was intended as a sort of legal textbook for law schools. See CHARLES M. RADDING & ANTONIO CIARALLI, *THE CORPUS IURIS CIVILIS IN THE MIDDLE AGES: MANUSCRIPTS AND TRANSMISSION FROM THE SIXTH CENTURY TO THE JURISTIC REVIVAL* 35 (2007). With the revival of interest in Roman law in northern Italy in the eleventh century, the *Corpus Iuris* was taught at the University of Bologna. Jurists and scholars trained in Roman law played a leading role in the creation of national legal systems throughout Europe.
36. See, e.g., THOMAS EDWARD SCRUTTON, *THE INFLUENCE OF THE ROMAN LAW ON THE LAW OF ENGLAND: BEING THE YORKE PRIZE ESSAY OF THE UNIVERSITY OF CAMBRIDGE FOR THE YEAR 1884*, at 76 (Lawbook Exch. 2010) (1885) (mentioning rescission in the context of Roman influence on English law); ZIMMERMANN, *supra* note 7, at ix-xi (generally describing the influence of Roman law on the early development of legal systems and jurisprudence of continental Europe and England without specific reference to the aedilitian remedies); Schermaier, *supra* note 8, at 80-85 (tracing the line of influence of the aedilitian remedies through the Middle Ages to modern European codifications and the English Sale of Goods Act of 1979). It is difficult to trace the influence of a specific Roman law rule on early common law. Common law was not a professorial law characterized by conceptual abstraction but rather a "jurisprudentia forensis, developing through lawyers' interpretations and judicial opinions." ZIMMERMANN, *supra* note 7, at xi. However, medieval common law had a striking resemblance to the aedilitian template: it allowed for a

In modern sales law, quality requirements enter contracts explicitly as stipulated in express warranties and implicitly through default contract law.<sup>37</sup> With respect to contract remedies, these quality terms serve two essential and separate functions. First, they act as a baseline for calculating compensation when delivery is nonconforming (as in the *actio quanti minoris*). Second, they establish thresholds that trigger the off-contract remedy of rescission followed by restitution (as in the *actio redhibitoria*).<sup>38</sup> We consider these functions in turn.

### B. Quality as a Baseline of Expectation

If warranted, quality enters contracts as a baseline for calculating compensation in the case of nonconforming delivery, the seller will have incentives to invest in quality, but the incentive generated by the warranty alone will generally be insufficient.

Consider a situation in which the seller can invest in quality. Investing more in quality makes production of higher-quality goods more likely but not certain. External factors may still undermine the seller's investment,  $r$ , such that goods of low quality are produced despite best efforts. Even the most careful producers sometimes end up with low-quality goods; they just do so less often than others. Likewise, a producer with weak quality controls and correspondingly low investments in quality can, by a stroke of luck, produce high-quality goods. Hence, sellers only have partial control over the quality of the goods they produce. Buyers place value on those goods, which we assume ranges between 0 and  $v_h$ , where  $v_h$  represents the value of the highest-quality good that can be produced at the current state of technology.

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contractual action for damages for failure to perform a contractual obligation. "[I]f a condition to the whole validity of a contract failed," the plaintiff could also rescind. DAVID IBBETSON, A HISTORICAL INTRODUCTION TO THE LAW OF OBLIGATIONS 223 (2001). Moreover, English medieval law only recognized damages for breach of warranty if the plaintiff suffered loss from the defendant's deceit, *id.* at 84, similar to the *dolus* requirement in classic Roman law, *see supra* note 28.

37. The rule under which courts require the good to be fit for its ordinary purpose is referred to as the "implied warranty of merchantability." U.C.C. § 2-314 (2003). Implied warranties may also "arise from course of dealing or usage of trade." *Id.* § 2-314(3). Moreover,

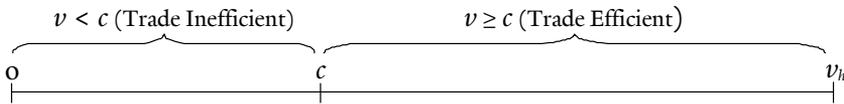
Where the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is . . . an implied warranty that the goods shall be fit for such purpose.

*Id.* § 2-315.

38. Along this line, quality thresholds also trigger the on-contract remedy of rejection.

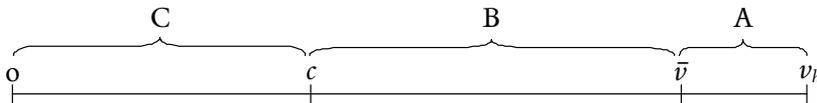
From a social welfare perspective, delivery is desirable if a level of quality results such that the buyer's value,  $v$ , exceeds the seller's variable cost of delivery,  $c$ .<sup>39</sup> Otherwise, no trade should occur from an ex post efficiency standpoint.

**Figure 2.**  
RANGE OF EFFICIENT TRADE



What about investment efficiency? Efficiency demands that the seller invest to increase the gains from trade, but she should only care about the range where trade is efficient (as shown in Figure 2). Suppose that the seller has warranted a particular quality level of  $\bar{v}$ . Figure 3 shows again the range of values from the lowest quality to the highest, with cost,  $c$ , dividing the range into areas where trade is efficient and inefficient. Quality level  $\bar{v}$ , the level required under the contract, breaks up the efficient trade area. If realized quality turns out to be greater than or equal to  $\bar{v}$ , the delivery is conforming (segment A), and the seller gets her price and incurs production cost.

**Figure 3.**  
SEGMENTED RANGE OF POSSIBLE QUALITY LEVELS

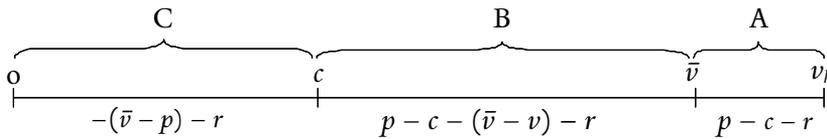


Therefore, the seller's payoff is  $p - c$  over segment A, the conforming region. Of course, the seller has already incurred her investment cost,  $r$ , which needs to be deducted to calculate the overall payoff to the seller. If the seller delivers goods of nonconforming quality and the buyer affirms the contract, then the buyer has to pay the price but can seek compensation for the nonconformity. Under expectation damages he can ask to be put in the position in which he would have found himself had the contract been

39. If, before production, the seller learns about the value of the good to the buyer, we can also interpret  $c$  as the seller's cost of production.

performed as stipulated. Since the seller's obligation was to deliver required quality  $\bar{v}$ , the buyer is entitled to compensation of  $\bar{v} - v$  for partial breach. Hence, the seller's overall payoff is  $p - c - (\bar{v} - v) - r$ . If the seller does not deliver at all, the buyer is entitled to compensation of  $\bar{v} - p$  for total breach, giving the seller an overall payoff of  $-(\bar{v} - p) - r$ .<sup>40</sup> Figure 4 summarizes the seller's payoff depending on the quality level that she produces.

**Figure 4.**  
SELLER'S PAYOFF AS A FUNCTION OF PRODUCED QUALITY



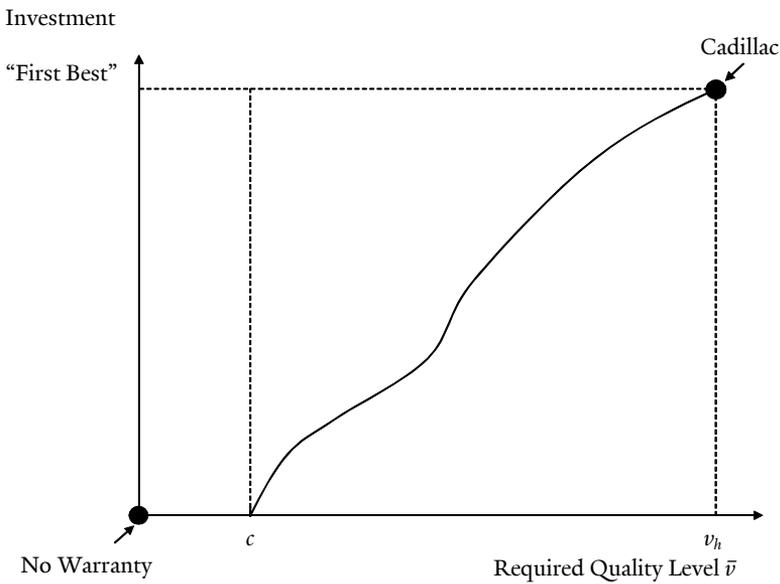
It is now very easy to see that there are positive incentives to invest but that they are generally lower than the socially desirable level. Recall that efficiency requires that the seller invest to increase the gains of trade,  $v - c$ , where trade is socially beneficial (segments B and A). Looking at the incentives created by warranties acting as a baseline for compensation we can see that, in segment B, any increase in the quality level benefits the seller as it reduces her damages payment  $\bar{v} - v$ .<sup>41</sup>

40. Note that the seller prefers paying compensation for total breach (segment C) over paying compensation for partial breach (segment B) whenever the value of delivery is lower than the cost of delivery ( $v < c$ ). This is an instance of the well-known result that expectation damages induce "efficient breach" by the promisor. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 119-20 (7th ed. 2007); Robert L. Birmingham, *Damage Measures and Economic Rationality: The Geometry of Contract Law*, 1969 *DUKE L.J.* 49; Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *YALE L.J.* 568 (2006); 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). In the present context, this property holds under the plausible assumption that  $c < p < \bar{v}$ , namely that the price is set between the variable cost to the seller and the value the buyer attaches to a good of conforming quality. It is possible to prove that the same payoffs would result if the buyer were allowed to reject a nonconforming tender. See Alexander Stremitzer, *Standard Breach Remedies, Quality Thresholds, and Cooperative Investments*, 28 *J.L. ECON. & ORG.* (forthcoming 2012) (manuscript at 9 & n.12), available at <http://jleo.oxfordjournals.org/content/early/2010/07/28/jleo.ewq007.full.pdf+html>.

41. Note that the payoff in section B can be rearranged as  $v - c - (\bar{v} - p) - r$ , which highlights that it equals the social payoff  $v - c - r$  minus a constant.

In segment A, however, the seller receives a fixed payoff,  $p - c$ , irrespective of how much the realized level of quality exceeds the threshold level  $\bar{v}$ . Hence, the seller does not fully internalize the benefit of her investment and rationally underinvests relative to the socially optimal level (“first best”).<sup>42</sup> Yet as  $\bar{v}$  increases, segment B increases at the expense of segment A, and investment incentives improve until finally reaching first-best levels if the highest possible quality is warranted,  $\bar{v} = v_h$  (“Cadillac” contracts).<sup>43</sup> Figure 5 captures these results with a graph, depicting the level of quality investments that result from different levels of contractually required quality.

**Figure 5.**  
INVESTMENT AS A FUNCTION OF REQUIRED QUALITY



42. In our model, the socially optimal level of investment and the investment level maximizing the joint surplus of the two parties are identical.

43. See Stremitzler, *supra* note 40, at 12. The underlying model is quite general, showing that the proven effects do not depend on the specific shape of any particular production technology. At this level of generality it is only possible to show that investment incentives strictly increase as contracting parties set the required quality level higher. Hence, the particular way in which the graph in Figure 5 is drawn only serves to illustrate that the relationship is not linear or otherwise well behaved beyond the fact that it is strictly increasing.

To avoid any confusion, it should be understood that this does not mean that the highest possible quality is actually produced all of the time. Such a scenario would clearly not be socially desirable. The warranty simply serves to establish the baseline from which damages are calculated and does not define the quality level that will be produced. A real-world example of such Cadillac contracts is the kind of contracts offered by moving companies.<sup>44</sup> Such contracts usually promise to deliver all the client's belongings intact. This is as valuable as the company's performance can be; most of the time, the company falls short of its promise and has to compensate its client.

However, we do not generally observe contracts that are breached so often. One might be concerned about the transaction costs involved in assessing and haggling about damages. Moreover, a contract that, by design, is breached almost all of the time is at odds with the very idea of a contract as a promise.<sup>45</sup> For these reasons, and perhaps others, Cadillac contracts, specifying the highest possible quality, are rarely observed in practice. This leaves us with the conclusion that, whenever quality enters the contract merely as a baseline for calculating compensation, the seller has incentives to invest in quality, but her investment will generally not be fully adequate to ensure the socially efficient outcome.<sup>46</sup>

### C. Quality as a Trigger of Rescission

Whenever, according to the background legal regime to a particular contract, it is possible for the buyer to elect between expectation damages and rescission followed by restitution, the buyer's decision to rescind is determined by two factors: the value of the goods (which he must relinquish under restitution) and the contract price (which he gets back). As restitution is often bad for the seller, especially if the goods' resale value is low, the seller will want to reduce the incidence of the buyer's choice of rescission followed by

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44. Credit for this example is due to Aaron S. Edlin, *Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages*, 12 J.L. ECON. & ORG. 98 (1996).

45. See, e.g., CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* (1981).

46. If required quality is not explicitly specified in the contract but follows from the interpretation by courts, it is plausible to assume that courts take into account the price term in their determination of implied quality. This might distort prices upward because the buyer faces a tradeoff. He wants to increase the price in order to achieve better incentives for investments in quality that increase the joint surplus of the trading parties. At the same time, he does not want to leave too much of the surplus to the seller. The parties will therefore agree on a price that is higher than if the incentive problem did not exist but lower than what would be needed to make courts interpret implied quality to be Cadillac quality.

restitution. She can do so either by setting a lower price or by increasing investments in quality, which makes it less likely that the buyer will have a legal right to rescind.

Hence, the availability of rescission creates incentives for the seller to invest in quality. As we will see, in such a regime it is possible to create optimal incentives for quality investments without writing Cadillac contracts (investment efficiency).<sup>47</sup> A second potentially positive effect of rescission is that it can lead to redistribution of surplus from sellers to buyers (redistribution effect). This is often considered to be desirable in its own right. Yet there may also be a positive effect in the absence of political preferences or wealth effects. If sellers have considerable market power, the availability of restitution may help to restrain this market power (procompetitive effect).<sup>48</sup> On the other hand, the availability of rescission will sometimes lead the buyer to return a good although it would be efficient for him to keep it (inefficient trade). We consider these effects in turn below.

### 1. *Ex Ante Investment Efficiency*

A legal regime that always granted the remedy of rescission and restitution to both parties would effectively not enforce contracts at all. After investments are made, the distribution of surplus between the parties becomes a zero-sum game. This implies that, whenever one party prefers to carry out the terms of the contract over rescinding the contract and determining the terms of trade in free renegotiations, the other party automatically prefers the opposite. Hence, contracts would always be rescinded and subsequently renegotiated. Anticipating renegotiation after relationship-specific investments are sunk, the seller underinvests, as she knows that the buyer would capture part of the surplus generated by her investment. This is the famous hold-up problem.<sup>49</sup>

47. For a formal analysis of this point, see Richard R.W. Brooks & Alexander Stremitzer, *On and Off Contract Remedies Inducing Cooperative Investments* (Yale Law & Econ. Research Paper No. 396, 2009), available at <http://ssrn.com/abstract=1524327>. Kull only considers the possibility of overinvestment—yet there could be underinvestment, such as if every quality level is considered to be conforming, as implicitly assumed in Yeon-Koo Che & Tai-Yeong Chung, *Contract Damages and Cooperative Investments*, 30 RAND J. ECON. 84 (1999).

48. For a formal analysis of this point, see Alexander Stremitzer, *Opportunistic Termination*, 28 J.L. ECON. & ORG. (forthcoming 2012), available at <http://jleo.oxfordjournals.org/content/early/2010/05/21/jleo.ewq004.full.pdf+html>. The effect can only occur if there is a positive chance that renegotiations are not possible.

49. See, e.g., OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 61-67 (1985); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL.

Yet the legal right to rescind is not available when the tender conforms to the contract. A regime that allows the buyer to elect rescission only if the right is triggered by nonconforming delivery can not only overcome the hold-up problem that arises if rescission rights are always available; it also allows contracting parties to set optimal incentives for quality investments without writing Cadillac contracts (which they would have to do if only expectation damages were available). Indeed, it can be shown that for every possible quality level, it is possible to choose a price such that incentives to invest in quality are optimal.

The claim that it is possible to achieve optimal investment incentives for every quality level between the lowest quality, 0, and the highest achievable quality,  $v_h$ , is a strong one and not obviously true. We formally demonstrate its validity elsewhere.<sup>50</sup> Here, we shall merely illustrate the kind of reasoning behind the claim. Assume, for convenience of the illustration, that the quality level stipulated by the parties is set very low, lower even than the expected quality.<sup>51</sup> It might seem odd at first to imagine that the parties would ever stipulate a quality level lower than that expected or desired, but familiar real-world examples exist. Parties sometimes stipulate low requirements to ensure the counterparty's success or to signal commitment while anticipating much more than the minimum specified performance. Law firms, for instance, often place relatively trivial requirements on their summer associates, knowing that most will far exceed the low threshold. This is similar to the case of the Cadillac contract in which the parties stipulate the highest possible quality level but do not actually expect the seller to produce such quality. Here, the parties stipulate a very low level but expect the seller (in the example above, the summer associate sells her labor) to produce much higher quality. The threshold level  $\bar{v}$  serves merely as the baseline for calculating damages or as a trigger for rescission rights.

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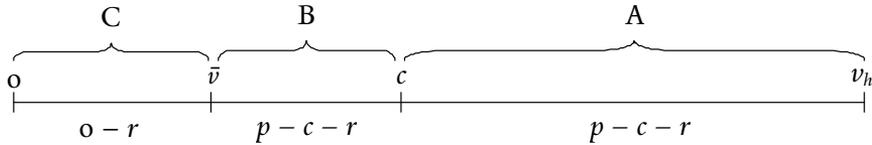
ECON. 691 (1986); Paul A. Groot, *Investment and Wages in the Absence of Binding Contracts: A Nash Bargaining Approach*, 52 *ECONOMETRICA* 449 (1984); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 *ECONOMETRICA* 755 (1988); Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 *J.L. & ECON.* 297 (1978); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & ECON.* 233 (1979).

50. See Brooks & Stremitzer, *supra* note 47.

51. The reasoning with higher stipulated quality levels is similar but a bit more complicated to describe.

We assume that the parties write a simple contract in which they specify a price  $p$  and a required quality level  $\bar{v}$ , which serves both as a baseline for calculating expectation damages and as the quality threshold that triggers the right to rescind if actual quality  $v$  falls short of  $\bar{v}$ . Figure 6 depicts this case along with the seller's payoffs at each quality realization.

Figure 6.  
SELLER'S PAYOFFS WITH LOW WARRANTED QUALITY  $\bar{v}$



The seller derives a payoff of  $p - c - r$  if the quality is above the threshold (segments A and B)<sup>52</sup> and a payoff of  $-r$  otherwise (segment C).<sup>53</sup> Hence,  $p - c$  acts as a quality premium for the seller. The higher this premium, the higher the seller's investment will be, as, by investing, the seller can increase the probability of exceeding the contractually specified minimum quality level. If the quality premium is 0, (that is, if parties set the price at  $p = c$ ) the seller's payoff would be  $0 - r$  across all segments. A rational seller in such a situation would choose zero investment ( $r = 0$ ) as investing only decreases the seller's payoff. Now take the other extreme. Parties could stipulate a very high price,  $p > c$ . Then the quality premium would be so high that investment incentives for the seller could also reach arbitrarily high levels, as the seller does not want to risk not getting the premium. Therefore, it is possible to make the seller overinvest by setting a sufficiently high price. Hence, by choosing an appropriate intermediate price,  $p$ , the parties can induce every intermediate investment level, including the socially optimal level.<sup>54</sup> This is the price level that rational parties should set.<sup>55</sup>

52. Note, however, that the interval in which quality is above the threshold is divided into two segments: one where trade is ex post efficient as value exceeds cost of performance (segment A) and another where trade is ex post inefficient (segment B). Therefore, although the seller's payoffs are the same in both segments, the actual allocative decisions taken by the parties are quite different. In segment A, the contract is performed, and the seller receives the agreed-upon price  $p$  but incurs cost of performance  $c$ . In segment B, the seller is willing and able to deliver goods of conforming quality, which, if accepted by the buyer, would leave the buyer with a payoff of  $v - p$ , but if rejected would constitute breach for which the buyer would have to compensate the seller with her expected profit of  $p - c$ . Because it is the case in segment B that  $c > v$ , it follows that the buyer prefers paying the seller her

If expectation damages are the only available remedy, then investment incentives are determined by the size of the damage payment to the buyer,  $\bar{v} - v$ , which is based on the contractually stipulated or implied quality level. If rescission is also an option, then price, in addition to quality, plays a role. With the rescission option there are two levers for adjusting incentives: the quality threshold and price.<sup>56</sup> When price acts as a lever to adjust incentives, however, it is not available as a tool to distribute the surplus among the parties.<sup>57</sup> To achieve the distribution of surplus that reflects the parties' respective bargaining powers, the parties therefore have to rely on up-front payments. These payments are independent of what otherwise happens in the contractual relationship. If, for example, the price required to induce optimal investment is very low, the seller would be willing to accept the contract only if the buyer makes an "unrefundable down payment" or pays some money as a "flat-cost reimbursement." On the other hand, if the price needs to be very high, the buyer will accept the contract only if he receives some up-front payment in money or in kind from the seller. This could, for example, consist of extra services that the seller performs free of charge.

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expectation interest over accepting the good as  $-(p - c) = c - p$  is greater than  $v - p$ . As no rescission rights are triggered, the contract is effectively governed by expectation damages in segments A and B, which are known to induce ex-post-efficient breach by the parties. See *supra* note 40 and accompanying text.

53. If the quality of the proposed solution falls below threshold  $\bar{v}$ , the buyer can elect between rescission and expectation damages. If he chooses rescission followed by restitution, the seller derives a payoff of zero. If the buyer opts for expectation damages, the seller has to pay the buyer his expectation interest  $\bar{v} - p$  whenever this expression is positive (as damage payments are truncated at zero). If parties stipulate a price that is at least as high as the cost of project implementation ( $p \geq c$ ), it follows that the damage payments are zero, as it can be seen from Figure 6 that the threshold value is lower than price,  $\bar{v} < p$ . Hence, the seller's payoff in segment C is zero minus the cost of investment,  $0 - r$ .
54. Strictly speaking, it is also necessary to prove that the seller's expected payoff as a function of investment must be concave at this price. See Brooks & Stremitzer, *supra* note 47, for the formal proof that this condition holds for the price that induces the socially optimal investment level.
55. A similar effect can be obtained by combining the off-contract remedy of rescission followed by restitution with the on-contract remedy of specific performance. See Stremitzer, *supra* note 40, for a formal analysis of this effect.
56. Technically, our result implies that only price is needed; for every quality threshold there exists a price that sets efficient incentives.
57. That is the role of the price in the case where only expectation damages are available as a remedy.

Another aspect to keep in mind is that our general result relies on the possibility of renegotiation. For instance, it can happen (though not in the example we gave to illustrate our argument) that the buyer chooses to rescind the contract although there are potential gains from trade. In these cases we assume that parties will always renegotiate toward the efficient ex post trade decision, splitting the surplus between them.

Our result is applicable to a wide range of contracts. It can be used in construction contracts where, for example, the owner of a large suspension bridge wants to incentivize the contractor to invest in innovative dampers to reduce the vibration of the cables.<sup>58</sup> It can be used in production contracts, such as where a patron wants to incentivize his tailor to employ care in designing his bespoke suit or where a car manufacturer who has outsourced the development of a new motor wants to create incentives for the engineering firm to invest efficiently in the motor design. The mechanism can also be used in lease contracts by a tenant who wants to create incentives for the landlord to invest efficiently in the maintenance of the apartment. In principle, it can also be used in insurance contracts: a policyholder could make the insurer invest efficiently in the quality of its claims-handling, or an insurer could make a policyholder invest efficiently in providing accurate information about underlying risks.

Yet the insurance contract serves to illustrate an important restriction of our argument. First, our result relies on the fact that the rescinding party can make the counterparty suffer in the case of rescission. This would be the case where a policyholder has an expensive house insurance policy on which he has paid premiums for years and where he rescinds when the insurance company does not honor a claim for a stolen bicycle. On the other hand, there are some types of insurance, such as accident and life insurance, where the payout to the policyholder if the insured event occurs is a multiple of the sum of prior premium payments received by the policyholder. In these cases, the threat of rescission carries no bite since the insurer would be delighted to have the policyholder rescind and therefore forgo his claim. The second limitation of our result is that, while it is possible through rescission rights to create incentives to take care, the remedy might expose the party that is rescinded against to the risk of being harshly punished if it turns out that it made a

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58. Remember that the parties can structure the contract in a way such that the contractor gets a positive payoff if the dampers are able to reduce vibration below acceptable levels but makes the contractor lose his investment if the quality of the dampers is nonconforming and therefore allows the owner to rescind. Hence, the contract employs both carrots and sticks to achieve the desired investments in damper quality. For a case study of a real-world project in which this problem played a role, see Daniel Alterbaum et al., *The Øresund Bridge: A Case Study in the Optimization of Construction Contracts* (2010) (unpublished manuscript) (on file with authors).

mistake. This would not be a problem if the party exposed to the risk of rescission were risk neutral, but in the case of insurance contracts it is clear that the policyholder is not risk neutral; otherwise, he would not be purchasing insurance.<sup>59</sup>

Finally, in many situations there are already strong investment incentives because of market pressures. A company might invest in quality just to maintain a good reputation in the market. One might be concerned that creating extra incentives to invest in quality through the legal system might add to the incentives already present and, at times, could lead to overinvestment. This concern, however, is unfounded, as incentives do not add up in such an intuitive way. The reason that the legal regime we describe induces efficiency is that it makes the investing party face an expected payoff function from the transaction, which is maximized at a socially optimal investment level. This implies that beyond that level, the extra cost from investing in quality exceeds the extra benefit. Therefore, if investment levels are positive for some exogenous reason, the legal regime creates additional incentives only to the extent that they fall short of the optimal investment level. Of course, it may be the case that exogenous factors, like career concerns, by themselves prompt sellers to invest too much in quality.<sup>60</sup> In these cases, the legal regime we describe can do nothing to reduce these excessive incentives, but it does not make them worse either.

## 2. *Redistribution*

If a seller delivers a good that does not conform to the contract, American legal principles,<sup>61</sup> as well as European warranty law,<sup>62</sup> allow buyers to choose between some money transfer and rescission. Rescission rights are widely criticized, however, mainly because people fear that the buyer can resort to “opportunistic rescission” or, in other words, use nonconformity as a pretext to

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59. In addition, there could be interesting cross-subsidization effects if the fact of a nonconformity is only discovered in the unlikely case that the insured event occurs. See Brian Barnes, Note, *Against Insurance Rescission*, 120 YALE L.J. 328 (2010).

60. See Bengt Holmström, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. ECON. STUD. 169 (1999) (describing the likelihood of this result in situations in which a company or an employee is unknown and young and expects huge returns from establishing a good reputation early on – not unlike the law firm summer associate described in this text).

61. See George L. Priest, *Breach and Remedy for the Tender of Nonconforming Goods Under the Uniform Commercial Code: An Economic Approach*, 91 HARV. L. REV. 960 (1978); see also *infra* note 86 and accompanying text.

62. See Francesco Parisi, *The Harmonization of Legal Warranties in European Sales Law: An Economic Analysis*, 52 AM. J. COMP. L. 403, 420 (2004).

avoid the consequences of a contract he no longer wants.<sup>63</sup> This would allow him to “speculate at the cost of the debtor.”<sup>64</sup>

The law uses several techniques to restrict rescission rights. Most importantly, it may require that nonconformity exceed a certain threshold level.<sup>65</sup> Yet the possibility of opportunistic rescission might actually have positive effects. Under some circumstances, it will lead to redistribution in favor of the buyer without too much loss of efficiency. Moreover, by curbing the monopoly power of the seller, a regime involving rescission serves a procompetitive function and thereby may increase welfare.

The intuition of the effect is easy to understand. If the buyer rescinds the contract, he recovers the price but has to return the good. He will therefore want to rescind whenever price exceeds his valuation for the good. Hence, the attractiveness of rescission increases with price. Now consider a legal system that allows the consumer to rescind the contract whenever the good is defective. Then, if the consumer buys, for example, an expensive suit but later changes his mind, he may be quite happy to find a little flaw, which allows him to rescind the contract and to recover the price. If, however, the suit were less expensive, he might decide to keep it.<sup>66</sup> Obviously, rescission followed by restitution often hurts the seller. She will only be able to resell a used suit at a large discount, if at all. A profit-maximizing seller might therefore lower the price in order to reduce the probability of the buyer choosing rescission.<sup>67</sup> It is important to understand that the seller is not able to adjust the contract price in order to make the consumers pay the bill for the expansion of their rights. The availability of rescission therefore presents an exception to the general argument that contractual remedies cannot be used to redistribute income, as parties would always adjust the contract price such that payoffs reflect their respective bargaining power.<sup>68</sup>

63. See, e.g., *id.* at 420-21; Priest, *supra* note 61, at 966.

64. PETER SCHLECHTRIEM & MARTIN SCHMIDT-KESSEL, *SCHULDRECHT ALLGEMEINER TEIL* ¶ 534 (6th ed. 2005) (translation by authors).

65. See *supra* note 27.

66. He might still ask the seller for some little voucher to compensate him.

67. For a formal analysis of this point, see Stremitzer, *supra* note 48.

68. See, e.g., A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 150 (3d ed. 2003); Richard Craswell, *Passing On the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 *STAN. L. REV.* 361 (1991).

It is worth noting that this effect cannot operate in perfectly competitive markets where sellers will earn zero economic profit and cannot further reduce the price. But as soon as the seller has some monopoly power to set prices, the effect leads to redistribution in favor of the buyer.<sup>69</sup>

### 3. *Ex Post Trade and Expenditure Decisions*

Rescission sometimes leads to inefficient returns. That is a real cost of the remedy. Even when goods are defective and their value lower than the contracted price, often it will be the case that they are still more valuable to the buyer than to the seller. Yet the buyer will prefer to leave the goods with the seller and get his money back. This is problematic if renegotiation is impossible or very costly. When Coasean bargaining cannot be relied on to return the goods to the buyer, efficiency is sacrificed. However, it is important to recognize that credible, albeit sometimes inefficient, returns are part of the off-equilibrium threat, which makes the seller adapt by lowering the price or increasing investments in quality. These adjustments in the seller's behavior considerably reduce the frequency with which the buyer chooses rescission, while promoting increased overall trade and social welfare as described above.

In addition to suboptimal returns, rescission followed by restitution may provoke a second type of ex post inefficiency—that is, after ex ante investments are made and the value of contractual exchange is known. Examples are not hard to find.<sup>70</sup> Take, for instance, the case of Hyman-Michaels Co., a large

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69. However, this positive effect hinges on the assumption that parties do not renegotiate once the buyer declares that he will terminate the contract—or at least that renegotiation is not possible all of the time. If renegotiation is possible, the buyer may (threaten to) return the suit but later renegotiate and keep it. This possibility allows him to extract a rent from the seller who is willing to make concessions in order to avoid ending up with a suit that has very little value to her. Anticipating this hold-up, the seller will expend inefficiently high resources in order to prevent nonconformity, which allows the buyer to terminate in the first place.

70. The most infamous example is *Boomer v. Muir*, 24 P.2d 570 (Cal. Dist. Ct. App. 1933), which involved a subcontractor, Boomer, who, after realizing that he was in a losing contract, brought an action of rescission followed by restitution to recover value created by his partial performance. The original contract price for Boomer's service was over \$300,000, all of which had been paid except for the final \$20,000. Hence, Boomer's expectation damages were \$20,000, which the court disregarded when it ordered Muir to pay him \$258,000 in restitution. The magnitude of such a payoff in restitution compared to damages in contract can create strong incentives for a party to search for, or even induce, a cause of rescission. For useful discussions of *Boomer* and other cases, see LAYCOCK, *supra* note 14, at 648-52; and Andrew Kull, *Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts*, 79 TEX. L. REV. 2021, 2041 n.48 (2001).

Chicago scrap metal dealer, which in June 1972 chartered the vessel *Pandora* for shipments to Brazil.<sup>71</sup> Charter rates were very low at the time of contract formation, but that soon changed: “Shortly after the agreement was signed, however, charter rates began to climb and by October 1972 they were much higher than they had been in June. The *Pandora*’s owners were eager to get out of the charter if they could.”<sup>72</sup> The *Pandora*’s owners spent resources trying to find a way out of the contract, and Hyman-Michaels spent resources defending against the owners’ efforts. The owners were ultimately able to rescind the contract by claiming breach when Hyman-Michaels’s payment was slightly delayed, and thereafter “Hyman-Michaels . . . promptly subchartered the *Pandora* at market rates.”<sup>73</sup>

Ultimately, the trade decision regarding the *Pandora* seems to have been an efficient one. The scrap metal dealer, which apparently valued use of the vessel more than its owners did, was able to use the ship, albeit at a higher price—but that is only redistribution. Yet there was a source of ex post inefficiency in this case, namely all the resources, financial and managerial, spent in arbitration and in anticipation of litigation. These transaction costs did not prohibit efficient Coasean exchange, but they were a wasteful and inefficient burden nonetheless and must be recognized as a cost of rescission in the hands of strategic and opportunistic parties.<sup>74</sup> Much of the mischief here is regulated by the materiality condition that triggers the election to rescind. Still, the regulation is imperfect, and whatever the remaining costs of this ex post strategic behavior, they must be weighed against the potential ex ante investment efficiency identified above. Moreover, these deadweight costs may serve the redistributive function described in the prior section.<sup>75</sup> Indeed, in large construction projects, owners with high bargaining power are keenly aware of the cost they face in terms of obstruction if their contractors are losing money, and they try to prevent this from happening, presumably by giving up some of their ex ante bargaining power.<sup>76</sup>

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71. *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951 (7th Cir. 1982).

72. *Id.* at 952.

73. *Id.* at 954.

74. See Kull, *supra* note 11, at 1472 (“It is difficult to think of a clearer incentive to inefficiency in the contractual relation.”).

75. As we mentioned, the redistribution effect hinges on the fact that renegotiation is not always possible. See *supra* note 48. Any cost that increases this deadweight loss—like the cost due to strategic behavior in the case of the *Pandora*—potentially increases this redistribution effect.

76. See Alterbaum et al., *supra* note 58 (manuscript at 37-47).

### III. RESCISSION FOLLOWED BY ON-CONTRACT REMEDIES

#### A. Traditional View (*Rescission and Restitution*)

Our focus to this point has been rescission followed by off-contract remedies found in restitution. Restitution as a basis of liability,<sup>77</sup> following rescission, aims to put the parties in the status quo ante—their respective positions before the contract was formed.<sup>78</sup> In the prototypical case, where the promisee pays up-front for goods or services that the promisor does not deliver, restitution merely requires a return of the price. In more complicated cases, such as where the promisee relies on the contract beyond price paid, putting the promisee in a precontract position would require payment of all reliance expenditures.<sup>79</sup> Or if the promisor exploited to great gain the monies briefly held as a consequence of the contract, restitution may call for disgorgement as a means of returning that party to the status quo ante.<sup>80</sup> Moreover, since it is often impossible to return both parties, simultaneously, to their respective precontractual positions,<sup>81</sup> courts may have to look to notions

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77. We emphasize that we are referring to restitution as a source of obligation, not as a measure of damages as it is sometimes understood.

78. Restitution is also referred to as *restitutio in integrum*.

79. See LAYCOCK, *supra* note 14, at 638 (“[A] buyer may have paid shipping costs in addition to the price. . . . Or he may have spent money trying to repair the goods before rescinding, or the defective goods may have damaged his other property.”). Laycock goes on to observe that “[c]ourts have generally allowed recovery of [such] nonduplicative damages.” *Id.*

80. Plaintiffs who recover price in restitution, for instance, are typically entitled to interest on price for the period it sat with defendants. See, e.g., *Mut. Benefit Life Ins. Co. v. JMR Elecs. Corp.*, 848 F.2d 30, 32 (2d Cir. 1988). Distinctions are sometimes drawn with respect to interest based on the type of breach. For example, in *Tennessee Carolina Transportation, Incorporation v. Strick Corp.*, 196 S.E.2d 711 (N.C. 1973), Strick Corporation manufactured and delivered 150 trailers to the plaintiff, a common cargo carrier. The trailers, however, “commenced breaking in-two when in use” by the plaintiff, who sued for breach after a failed attempt by Strick to repair the defective trailers. *Id.* at 714. Money damages for the breach were determined, to which the trial judge added interest. *Id.* at 716. The North Carolina Supreme Court reversed with regard to interest, holding that the relevant state law “was intended to provide for the recovery of interest as a matter of right only where *nonperformance*, not *defective performance*, constitutes the breach of contract sued upon.” *Id.* at 724. It would have been a different matter, the court argued, “[h]ad defendant delivered no trailers whatsoever.” *Id.* Potentially, had price been recovered through restitution, interest payments might have been permissible.

81. When, for example, the promisee relies by paying additional sums to third parties or the gains created by the promisor’s exploitation would not have been realized if the monies were kept by the promisee, reliance or disgorgement remedies will either leave the promisor worse off or leave the promisee better off than the status quo ante.

of fault or injustice to determine which remedy in restitution best balances the interests of the parties.<sup>82</sup>

Our analysis suggests that among the multiplicity of restitution remedies—including, among others, restoration, reliance, disgorgement, quantum meruit, and quantum valebant—restoration of price is one that clearly promotes mutually beneficial contracting between parties and may, more generally, enhance social welfare. Providing promisees a greater remedy than restoration of price after rescission can threaten the identified benefits described in the prior Parts of this Article. Though it has been argued that restitution following rescission should not be limited by contract price (because the contract no longer exists, the argument goes, it need not serve as a point of reference),<sup>83</sup> our results highlight important economic justifications for this limitation. If we were to reduce our insight to a simple formula, we would say: rescission should come at a price—that is, promisees who recover their money after rescinding should not be able to ask for additional contract damages.

This formula converges with the traditional view of rescission followed by restitution, where restitution is limited to restoration of benefits conferred to the other party. Yet a modern, more liberal view of the appropriate remedies following rescission is gaining ground. Proponents of this view would grant promisees expectation or reliance damages following rescission.<sup>84</sup> An immediate doctrinal question surfaces: is there any contractual basis for these remedies after an agreement is rescinded? Reliance may skirt the issue because it is available both on and off the contract, but expectation damages confront the question head-on. “As an original question,” Williston reluctantly conceded, “it might be argued with some force that the buyer should have a right to rescind . . . and yet hold [the seller] liable in damages for failure to keep his contract.”<sup>85</sup> We need not resolve the doctrinal question here because, irrespective of the legal basis, our points about the value of rescission “coming at a price” apply with equal force in contract. Though lacking the convergent

82. For example, unjust enrichment is the claimed basis for the remedy of rescission followed by restitution. See RESTATEMENT (SECOND) OF CONTRACTS § 373 cmt. a (1981) (stating that restitution as an alternative remedy for breach of contract seeks to protect the injured party’s interest by preventing “the unjust enrichment of the other party”). This is, however, far from a consensus view. See, e.g., Kull, *supra* note 11, at 1480–82.

83. See *Boomer v. Muir*, 24 P.2d 570, 577 (Cal. Dist. Ct. App. 1933); see also LAYCOCK, *supra* note 14, at 648–52 (presenting the competing arguments).

84. See *supra* note 28.

85. WILLISTON, *supra* note 34, § 612 (“The right of the buyer to recoup [price] . . . and yet to bring an action later to recover consequential damages for breach of the warranty, has been upheld in England in a leading case.” (citing *Mondel v. Steel*, (1841) 151 Eng. Rep. 1288 (Exch.))).

weight of established practice observed in restitution, our analysis should give pause to those who would liberally grant generous contract remedies following the return of defective goods.

*B. Rescission and Expectation Damages*

Should someone who returns defective goods and recovers the price also be entitled to expectation damages (cumulative concurrence), or should the two remedies be mutually exclusive (alternative concurrence)? As a matter of law, there are of course important distinctions in whether the goods are returned through rescission (annihilating the contract *ab initio*) or rejection (preserving the contract) followed by recovery of price. These distinctions, however, do not affect the economic character of the exchange. The goods are returned and the price recovered in either case. Hence, economic arguments for rescission coming at a price also apply in cases of rejection, in which it is generally accepted that expectation damages are still available after price has been recovered.<sup>86</sup> The inquiry here is not one regarding legal form. The question is about the economic effect of permissively allowing parties to return defective goods (through whatever legal device, rescission or rejection) and recoup damages on top of price.

To understand the ramifications of such a question, first consider the setting in which choosing expectation damages or rescission followed by restitution (which in this Section we treat as giving rise to restoration of price<sup>87</sup>) are mutually exclusive remedies. Figure 7 depicts the buyer's payoffs from choosing to either affirm or disaffirm the contract following breach. If the buyer affirms, he is entitled to expectation damages, which gives him the same payoff as if the contract had not been breached.<sup>88</sup> In other words, the buyer gets the value of contracted performance,  $\bar{v}$ , minus the contract price,  $p$ .<sup>89</sup> On the other hand, if the buyer disaffirms the contract, he is limited to restoration

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86. See *supra* note 28 (citing U.C.C. § 2-608 cmt. 1 (2003); LAYCOCK, *supra* note 14, at 638).

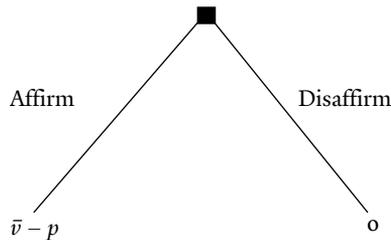
87. See *infra* Section III.C for an analysis where restitution is assumed to also give rise to reliance.

88. The breach may, of course, be because the seller has delivered substantially nonconforming goods or has not delivered at all.

89. If the seller has delivered nonconforming goods and the buyer affirms the contract, the buyer keeps the goods (valued at  $v$ ) and pays the contract price ( $p$ ) but collects damages equal to the difference in value between contracted performance and actual performance ( $\bar{v} - v$ ). As  $v - p + (\bar{v} - v) = \bar{v} - p$ , the resulting payoff is as depicted in Figure 7.

of price, which puts him in the neutral precontractual position, making his payoff zero.<sup>90</sup>

**Figure 7.**  
**BUYER'S PAYOFFS UNDER ALTERNATIVE CONCURRENCE**



Now imagine a case, depicted in Figure 8, where the buyer can choose expectation damages after having disaffirmed (cumulative concurrence). This means that on top of recovering price following rescission, the buyer has an option to seek a damage payment from the seller to give him the same payoff as if the contract had been performed. The buyer therefore gets a payoff of  $\bar{v} - p$  unless he has a losing contract (that is, unless  $\bar{v} - p$  is negative), in which case he gets a payoff of zero. Expectation damages are always at least zero because negative awards are not issued, which is to say that promisees with losing contracts do not have to compensate breaching promisors. We use the expression  $[\bar{v} - p]^+$  to denote that damages are truncated at zero.<sup>91</sup> Affirming the contract gives the buyer exactly the same payoff ( $\bar{v} - p$ ) as in the case of alternative concurrence.<sup>92</sup> Thus, the buyer strictly prefers to disaffirm the contract in exactly the same instances as under alternative concurrence, namely if  $\bar{v} < p$ . However, while under alternative concurrence the buyer strictly preferred to affirm the contract if the buyer's valuation of contracted quality was higher than price,  $\bar{v} > p$ , under cumulative concurrence he is now merely indifferent between affirming and disaffirming the contract, suggesting that the stability of contracting is much more fragile.

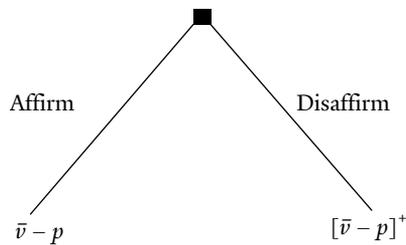
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90. In the case that the buyer has already paid up-front, he can recover the price but also has to return the nonconforming goods that the seller might have delivered to him. On balance, again, his payoff is zero.

91. The notation  $[\bar{v} - p]^+$  is a shortcut for  $\max[\bar{v} - p, 0]$ , which equals  $\bar{v} - p$  whenever  $\bar{v} - p$  is positive and which equals zero otherwise.

92. Note that, as the good is nonconforming, whenever the rescission right is triggered the damages payment ( $\bar{v} - v$ ) the buyer receives if he affirms the contract and keeps the good is always positive.

**Figure 8.**  
**BUYER'S PAYOFFS UNDER CUMULATIVE CONCURRENCE**



Note that disaffirming the contract means that trade will not occur; the goods are rejected or returned. This is inefficient if the value of the goods to the buyer exceeds the cost of delivery,  $v > c$ . If parties can renegotiate to reverse the buyer's decision to reject or return the goods (and this is a big "if" as there are many reasons to suppose they cannot),<sup>93</sup> they can do so at their mutual gain whenever  $v > c$ . Similarly, note that affirming the contract means that trade should occur. This is inefficient if the value of the goods to the buyer is less than the cost of delivery,  $v < c$ . Again, if the parties can renegotiate the inefficient trade decision, they will do so at their mutual gain.

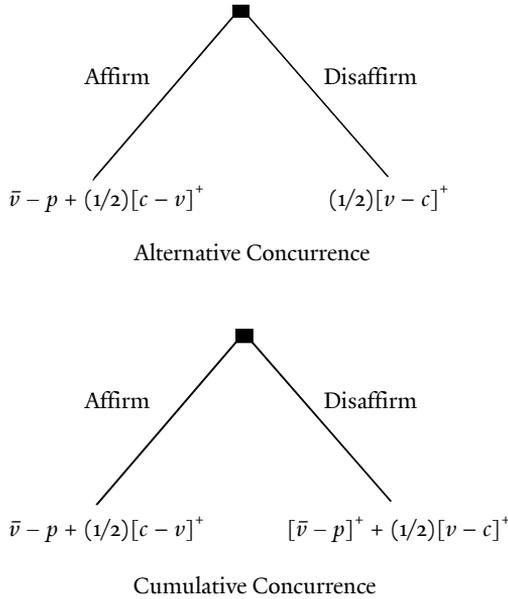
For the sake of concreteness, assume the parties split the gains from renegotiation equally.<sup>94</sup> Thus, if the buyer disaffirms an efficient contract trade, costless renegotiation would leave each party with an additional payoff of  $(1/2)[v - c]^+$ .<sup>95</sup> Similarly, if the buyer affirms an inefficient contract trade, each party derives an additional payoff of  $(1/2)[c - v]^+$  from renegotiation. In Figure 9, we account for the payoffs from renegotiation under alternative and cumulative concurrence respectively.

93. This can be due to transaction costs, asymmetric information, or a dysfunctional relationship after rejection.

94. Nothing hinges on the assumption of the parties splitting the gains from renegotiation equally. Any other sharing rule would lead to the same qualitative results.

95. If  $v$  is smaller than or equal to  $c$ , the opportunity to renegotiate will not generate any extra payoff, but neither will it cause any harm—the parties just do not reverse the buyer's decision to rescind.

Figure 9.  
EFFECT OF RENEGOTIATION ON BUYER'S PAYOFFS



From Figure 9, it is immediately apparent that disaffirming is more attractive under cumulative concurrence in that the buyer derives an additional payoff of  $\bar{v} - p$  whenever the buyer's valuation of required quality exceeds price,  $\bar{v} > p$ . If variable cost of delivery,  $c$ , is zero, disaffirming even becomes a dominant strategy under cumulative concurrence, but this is not the case under alternative concurrence.<sup>96</sup> In general, it holds that the probability that contracts are disaffirmed is strictly higher under cumulative than under alternative concurrence.<sup>97</sup>

96. To see this, note that if  $c = 0$ , the buyer's payoff under cumulative concurrence becomes  $\bar{v} - p + 0$  if the buyer affirms and  $[\bar{v} - p]^+ + (1/2)v$  if the buyer disaffirms. (Remember that the notation  $[c - v]^+$  is a shortcut for  $\max[c - v, 0]$ , which equals  $c - v$  whenever  $c - v$  is positive and which equals zero otherwise. See *supra* note 91.) The latter expression is obviously greater than or equal to the former, as  $v \geq c = 0$ . Under alternative concurrence, the buyer's payoff from affirming is  $\bar{v} - p$ , while it is  $(1/2)v$  for disaffirming. Which option leaves the buyer better off depends on the specific case at hand.

97. Affirmation under alternative concurrence occurs for  $v \leq 2(\bar{v} - p) + c$ , while under cumulative concurrence it occurs for  $v \leq \min[2(\bar{v} - p) + c, c]$ . The latter condition is obviously harder to satisfy than the former. To see this, consider the case where  $\bar{v} > p$ .

Therefore, while cumulative concurrence makes contracting more fragile in the absence of renegotiation, matters are more dire when renegotiation is feasible. Cumulative concurrence in a context where renegotiation is feasible strictly increases the likelihood of disaffirmation. In fact, this holds true whenever there is a positive chance of renegotiation. Hence, cumulative concurrence threatens the stability of contracting much more than if rescission and expectation damages are mutually exclusive.

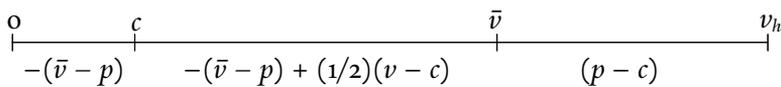
Moreover, cumulative concurrence annuls any realistic possibility of a redistribution effect. The most a seller can hope for by reducing the price is to make the buyer indifferent between affirmation and disaffirmation. If there is a positive chance of renegotiation, decreasing the price may often decrease the probability of disaffirmation under alternative concurrence while leaving the probability of disaffirmation under cumulative concurrence completely unaffected.<sup>98</sup>

Finally, cumulative concurrence makes providing incentives for optimal investment in quality much harder. This point is not obvious. A seller who fears that the buyer will threaten her with rescission will often have the incentive to invest in quality to make it less likely that the rescission right is triggered. However, it can be shown that the seller's expected payoff profile is such that it is no longer generally possible to induce first-best levels of investment if the required quality level,  $\bar{v}$ , is set higher than variable cost,  $c$ .

The intuition behind this argument can be seen in Figure 10, which shows that for certain production technologies and quality thresholds it may no longer be possible to use price as a quality premium. Price influences only the level of compensation but not the attractiveness of producing higher quality.<sup>99</sup>

Figure 10.

SELLER'S PAYOFFS UNDER CUMULATIVE CONCURRENCE AND RENEGOTIATION



98. This is the case if  $2(\bar{v} - p) + c > c$ . However, as mentioned previously, redistribution cannot occur if the probability of renegotiation is one. See *supra* note 48.

99. For details, see Brooks & Stremitzer, *supra* note 47.

Therefore, if courts are concerned about the stability and efficiency of contracting as well as the potentially desirable effects of redistribution from the seller to the buyer, they should treat rescission and expectation damages as mutually exclusive. The buyer should not be allowed to ask for damages beyond restitution if he has chosen to rescind. Rescission should come at a price.

*C. Rescission and Reliance Damages*

Rescission followed by restitution amounting to reliance does not provoke the same contractual dysfunctionality as the cumulative concurrence of rescission and expectation damages. There are two reasons for this. First, because price enters the damage measure (that is, reliance equals  $p + r_b$ ), the parties may use it as an instrument to secure an efficient transaction.<sup>100</sup> Second, cumulative concurrence of rescission and reliance does not necessarily render disaffirming a dominant strategy.

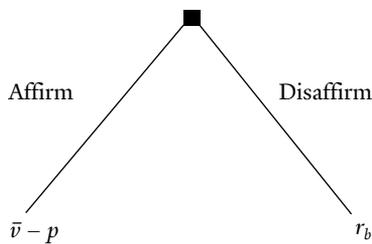
Figure 11 compares the buyer's payoffs from suing on the contract for expectation damages and receiving a reliance remedy following rescission. By affirming, the buyer receives the good (giving him  $v - p$ ) and can collect damages for partial breach ( $\bar{v} - v$ ), resulting in a total payoff of  $\bar{v} - p$ .<sup>101</sup> By disaffirming, he gets the price (if he paid up-front) and his reliance investments. The buyer will choose to affirm whenever the valuation of contracted quality is higher than the sum of the price and the reliance investment,  $\bar{v} > p + r_b$ . Otherwise, the buyer strictly prefers to disaffirm the contract.

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100. Note that the availability of the price term as a tool for efficient contracting is also behind some of the desirable properties of restoration of price as a remedy.

101. The expectation measure here is the familiar "diminution in value," sometimes called "difference in value," which grants the buyer a monetary payment equivalent to the value he would have received had performance been conforming minus the value he did receive from actual performance.

**Figure 11.**  
**BUYER'S PAYOFFS UNDER RESCISSION AND RELIANCE DAMAGES**



Because  $p + r_b \geq p$ , it is clear that the buyer will disaffirm more often when given the option of rescission followed by reliance, as opposed to rescission followed by restitution amounting to restoration of price. However, the stability of contracting is not affected only by the buyer's decision to rescind but also by the seller's decision to breach the contract by refusing to deliver. Breach by the seller can be strongly discouraged if the buyer is allowed to choose restitution amounting to reliance. So it is difficult to say whether disaffirmation will occur more often here, relative to the case where restitution gives rise to restoration of price.

Hence, reliance following rescission may be more defensible than expectation damages following rescission in terms of efficiency and stability of contracting.<sup>102</sup> Reliance following rescission is also more consistent with existing legal doctrine because reliance awards have long been granted under restitution whereas expectation damages have not. In many cases, of course, reliance and restoration of price simply do not differ, as implicitly modeled in this paper, wherein the buyer made no investments. A fruitful avenue of future research would involve developing a bilateral investment framework with on- and off-contract remedies.

## CONCLUSION

The ability to elect rescission followed by restitution allows parties to create incentives for efficient investment in quality, which cannot be taken for granted. Indeed, in the absence of rescission, only the extraordinarily demanding Cadillac contract—that is, a contract stipulating the highest

102. We treat stability of contracting as a value of its own here and do not relate it directly to welfare effects. One might, however, argue that more frequent breaching is likely to lead to higher transaction costs as more disputes arise.

possible quality level—will create efficient incentives to invest in quality. The availability of rescission followed by restitution alleviates this problem by allowing parties to stipulate any quality level (including those ordinarily observed in everyday contracting) while maintaining efficient investment incentives.<sup>103</sup> Moreover, rescission followed by restitution acts as a credible threat that may redistribute wealth from the seller to the buyer. This can lead to efficiency gains when the seller has monopoly power.

Whereas our approach could be summarized as “liberal access to rescission, conservative ensuing remedy,” modern reforms and reform proposals in the United States and around the world seem to embrace the opposite route of restricting access to rescission while also at times allowing for more generous ensuing remedies. This trend is disturbing and may be explained by a general modernist mistrust of robust self-help rights, which are often seen as a vestige of older, less advanced legal systems. Yet such conceit—our analysis suggests—may be at odds with the hidden law of exchange.<sup>104</sup>

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103. This is not to say that, in a regime permitting rescission, contracts cannot be written that would result in overinvestment. We simply establish that for every given quality threshold, parties can find a price that counterbalances underinvestment and overinvestment incentives in such a regime.

104.       The Hidden Law does not deny  
          Our laws of probability,  
          But takes the atom and the star  
          And human beings as they are,  
          And answers nothing when we lie.

          It is the only reason why  
          No government can codify,  
          And verbal definitions mar  
          The Hidden Law.

W.H. AUDEN, *The Hidden Law*, in COLLECTED POEMS 209, 209 (Edward Mendelson ed., 1976) (1940).