3.3 CONTRACT

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

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... The purpose of this essay is to begin the development of an integrated theory of contract remedies by delineating the circumstances under which courts should simply enforce a stipulated remedy clause or grant relief to the innocent party in the form of damages or specific performance. The conclusion, in brief, is that in the absence of stipulated remedies in the contract that survive scrutiny on the usual formation defenses, specific performance is more likely than any form of money damages to achieve efficiency in the exchange and breach of reciprocal promises. If specific performance is the routine remedy for breach, there are strong reasons for believing, first, that more mutually beneficial exchanges of promises will be concluded in the future and that they will be exchanged at a lower cost than under any other contract remedy, and, second, that under specific performance postbreach adjustments to all contracts will be resolved in a manner most likely to lead to the promise being concluded in favor of the party who puts the highest value on the completed performance and at a lower cost than under any alternative.

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

Efficient Breach

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

From an economic standpoint the answer is clear. Economic efficiency will be served if resources are allocated to their highest-valued uses while minimizing the cost of reallocation. Thus, if, as previously as-

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sumed, efficiency is our goal, contract law should specify a remedy for breach that will lead to ownership of the house by the person who values it the most, and should attempt to reach this result at the lowest possible resource cost. In this case, the house apparently has the greatest value to C: we know that he places a value of at least $125,000 on the house; B, by assumption, values it at $115,000; and A values it at something less than $100,000. . . .

Legal Remedies for Breach of Contract

Restitution

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

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

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

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

Reliance

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

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

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

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

An answer to this objection to reliance damages as the routine remedy is that the law already discourages B's over-reliance by protecting only reasonable reliance. That is, the law will not allow B to pile on expenses willy-nilly so as to bind A to perform. There is no doubt from an efficiency standpoint that this is the proper stance for the law, but there are other reasons to believe that allowing only reasonable reliance will still not guarantee only efficient breach. The most important of these is that determining which reliance expenses were reasonable and which were not is likely to be expensive. This is all the more true because the breachee has a strong incentive to demonstrate large reliance interest at the same time that the breacher has the contrary incentive to minimize that interest.

Expectation

The third interest of the innocent party that the law of contract damages protects is the expectation interest. Whereas with restitution and reliance the goal of the remedy is to place the innocent party in the position he was in before formation of the contract, with expectation damages the breachee is to be put in the position he expected to assume had the contract been performed. . . . In addition to being the most widely used contract remedy, expectation has attracted the favorable attention of economists because it is the only measure of contract damages that induces breach only where breach is more efficient than is performance.

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

While the theoretical attractiveness of expectation loss as a damage measure is straightforward, practical application of the measure is not. The crucial problem is to determine, after the breach has occurred, what the innocent party's expected profit was at the time that the contract was formed. Clearly, the promisee has a powerful urge, after a breach, to exaggerate the gain he had expected from performance while the promisor has equally strong feelings that the gain could never have been so large. Recall that this is precisely the problem noted above with reliance damages. . . .

The conclusion of the literature on the efficiency goal in damage measures for breach of contract may be briefly stated: the expectation interest is the only measure of damages that will lead to efficient breach. There are, nonetheless, some widely recognized problems that arise in the measurement of the breachee's expectation interest. In the case of buyer's breach, the seller's reasonably foreseeable profits from the completed contract should be taken as the measure of damages if the goal is to encourage only efficient breach. Yet there are well known pitfalls in computing lost profits. In the case of seller's breach, the buyer's expectation interest is his consumer surplus or subjective valuation of the completed contract. There are serious evidentiary problems in determining this amount. It is probably the case that stipulated damages, if enforced even with a seemingly punitive element, are a less costly way to protect subjective valuation than are expectation damages. It is as yet an open question whether the inefficiencies of the alternative legal remedies, restitution and reliance, are severe enough to offset the far greater ease and precision of measuring those alternatives to expectation. We have yet to discuss whether expectation, with its high costs of measurement, is a superior guarantor of only efficient breach than is the equitable remedy, specific performance. I turn to that discussion in the next section.

The Efficiency of Specific Performance

Damage payments are the legal remedy for contract breach; specific performance is the equitable remedy. Specific performance is a judicial order requiring the promisor to perform his contractual promise or forbidding him from performing the promise with any other party. If, for example, A has promised to sell a house to B for $100,000 but breaches in order to sell to C for $125,000, B might seek relief in the form of a court order requiring A to sell to B. Alternatively, B might ask the court for an injunction forbidding A to sell to anyone but B. As a general rule, court invokes equitable remedies only when it thinks that legal remedies are likely to offer inadequate relief, that is, to be under-compensatory. The granting of equitable relief is at the discretion of the court upon a demonstration by the plaintiff that damages will not adequately compensate him. The typical cases in which this under-compensation is said to arise are in the sale of "unique goods," the sale of land (considered by the law, largely for historical reasons, to be a unique good), and long-term input contracts. When an otherwise innocent party asks for specific performance, the breacher is permitted to mount defenses that are not usually available against a damage award: insufficient certainty of terms, inadequate security for the innocent party's performance, the breacher's unilateral mistake, and the high level of supervisory costs that the court might incur in enforcing performance.

The economic efficiency of this state of affairs is open to question. In particular, it is not obvious that the efficient exchange of reciprocal promises or the enforcement of valid contractual promises is best served where specific performance is reserved for the circumstances noted above.... In this section, I shall attempt to show that specific performance should be, on efficiency grounds, the routine contract remedy. The reasons for this conclusion may be briefly summarized here. First, if contractual parties are on notice that valid promises will be specifically enforced, they will more efficiently exchange reciprocal promises at formation time. In particular, they will have a stronger incentive than currently exists under the dominant legal remedy to allocate efficiently the risks of loss from breach rather than leaving that task, in whole or in part, to the court or to post-breach negotiations conducted under the threat of a potentially inefficient legal remedy. Second, and perhaps most importantly, specific performance offers the most efficient mechanism for protecting subjective values attached to performance. Thus, it promotes contract breach only if it is efficient, that is, if someone will be better off and no one will be worse off because of the breach. In this regard, specific performance and an expansive enforcement of stipulated remedies constitute integral and inseparable parts of a unified theory of efficient contract remedies. Third, if specific performance were the routine remedy, the post-breach costs of adjusting a contract in order to move the promise to the highest-valuing user would be lower than under the most efficient legal remedy. The central reason for this is that under specific performance the costs of determining various parties' valuation of performance are borne by those parties in voluntary negotiations. This means that the costs of determining willingness-to-pay are borne by those most efficiently placed to determine that amount. Finally, because the costs of ascertaining any subjective values of the innocent party through evidence presented to a court are so high and because, therefore, the possibility of undercompensating the innocent party through a damage remedy is high, specific performance is far less likely to be undercompensatory and far more likely to protect the breachee's subjective valuation than is any other judicially imposed contract remedy....

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

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

A crucial tenet of this argument is that money damages in the case of unique goods are likely to be under-compensatory and will, therefore, lead to inefficient breach. Thus, it is important to be clear about the sources of this under-compensation. The costs incurred in pre-contract search—those of locating sellers, obtaining information, comparing quality, and so on—are not generally recoverable if the contract is breached. In this respect what distinguishes fungible from unique goods is that, despite the breach, pre-contract search costs will bear fruit in the case of fungible goods but not in the case of unique goods. Therefore, money damages are likely to be under-compensatory in the case of unique goods.

[Furthermore,] Professor Kronman argues that promisors of unique goods, facing a thin market, will be more willing to accept a provision for specific performance than would be the case with fungible goods because the chances of his receiving a more attractive third-party offer are not very high. For nonunique goods and services, the promisor is more likely to receive alternative offers before he has fulfilled his contractual promise and is, therefore, more adamant about retaining the flexibility that comes with a money damages rule....

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

[T]his having been said, it is nonetheless the case that there is an important germ of truth in Professor Kronman's hypothesis. I believe that his contention would be completely accurate if it were revised to read as follows: If contracting parties were free to specify any remedy that was mutually agreeable, they would be likely to opt for specific performance rather than damages where the promisee attached some particular subjective valuation to the promisor's performance. The key difference here is the insertion that it is subjective valuation rather than uniqueness that makes specific performance attractive. Clearly, there is a relationship between uniqueness and subjective valuation: someone is more likely to attach a value greater than market value to a rare, one-of-a-kind item than to a highly fungible item. However, the class of things to which someone attaches a subjective valuation is greater than the class of unique items. Once his category is expanded to include all promises to which there is a subjective valuation, then the rest of Professor Kronman's analysis stands. . . .

Defenses

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

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

The contention is, in part, that high supervision costs will increase the costs of using specific performance as the routine remedy to the point that money damages are more attractive. Consider, for example, that if defendants know that they may be relieved of specific performance when they are able to demonstrate high supervision costs, then they have an incentive to raise that defense in cases where it may be inappropriate. Since this would, in general, raise the costs of litigation, it might make the otherwise more efficient remedy of specific performance more expensive and, therefore, less clearly efficient than money damages. A further contention is that since a far wider set of contracts than is commonly assumed involve high supervision costs, specific performance is inappropriate as the routine contract remedy.

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

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

The presumption that an award of specific performance will necessarily result in performance of the contract is incorrect. We have seen above that specific performance, like injunctive relief, should be understood as an instruction to the litigants to use the market, rather than the court, to solve their dispute. There is every reason to believe that if B is awarded a decree of specific performance against A to play Hamlet, the two will begin negotiations to resolve the dispute, with A presumably willing to pay B not to exercise his right to the contractual promise. B, for his part, may be willing to exchange that right rather than run the risk of incurring large expenses in policing A's portrayal of Hamlet. That is, it may be mutually beneficial to promisor and promisee to bargain out of performance. Although it is difficult to know a priori when this will happen, the possibility that there will be no performance in circumstances in which supervision costs of the performance would be high should lessen the concern about the inefficiencies that might result. Indeed, it may be that the proper way to consider the problem of high supervision costs is not that it puts extraordinary burdens on the legal system but rather that it merely gives the breacher a much better bargaining position in the post-breach negotiations than would be the case under a contract in which the quality of the breacher's performance was not solely in the breacher's hands. If that is the proper economic analysis of the matter of high supervision costs, then it may well be that specific performance is the preferred remedy there, too. Assuming that the promisor makes a credible threat that supervising the quality of his performance will be high, then the worst that can happen to the promisee is that he accepts, in return for not enforcing his right to specific performance, a price that reflects the contract price less the anticipated supervision costs. Such a conclusion would serve as an inducement for future contracts regarding personal services, or other high supervisory cost activities, to include liquidation clauses specifying responsibility for the costs of monitoring performance. Alternatively, promisees in situations of high supervision costs will discount the contract price they are willing to give a promisor by the probability of breach and by the level of anticipated supervision costs.

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

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

Summary and Conclusion

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