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EFFICIENT BREACH THEORY THROUGH THE LOOKING GLASS

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A party in breach of contract cannot sue the victim of breach to recover what would have been the victim's loss on the contract. The doctrinal rationale is simple: A violator should not benefit from his violation. This rationale does not, however, provide an economic justification for the rule. Indeed, efficient breach theory is founded on the proposition that a breach of contract need not be met with reproach. Yet the prospect of recovery by the party in breach—that is, the prospect of negative damages—has received scant attention in the contracts literature. Close analysis reveals potential costs to disallowance of negative damages, particularly where a party with private information about the benefits of termination also has an incentive to continue under the contract. These costs can arise both ex post, at the time of a performance-or-termination decision, and ex ante, in anticipation of that decision. Nevertheless, allowance of negative damages could impose its own costs, where background information would create an incentive to repudiate a contract before either party could gather more information, for example. Ex ante contractual provisions, such as liquidated-damages or specific-performance clauses, permit parties some latitude to balance the costs of disallowance and allowance of negative damages, albeit imperfectly. Common law limitations on the mitigation duty may be seen as a mechanism to approach this balance in the absence of an explicit contractual solution.

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INTRODUCTION

At the heart of efficient breach theory is the common law remedy of expectation damages. This remedy requires a party who breaches a contract to pay damages in an amount that would make the victim of breach as well off as she would have been had the breach not occurred. In principle, this gives each party to a contract an incentive to perform when performance is efficient but not otherwise. The parties, therefore, will complete those contractual projects that are valu-

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able and abandon those that are wasteful, all without potentially costly postcontractual renegotiation. Proponents of efficient breach theory applaud this result and reject any attempt to condemn or punish a party who breaches—even if the breach is an intentional repudiation—so long as the victim is compensated. Under basic efficient breach theory, no purpose would be served by inducing performance that costs the provider more than such performance benefits the recipient.

Efficient breach theory in its simplest form stops there, however, and though frequently refined, remains substantially incomplete because it neglects a category of cases that forms a conceptual half of efficient breaches. That is, efficient breach theory largely ignores those contracts for which one party's breach terminates a contract to the *benefit*, rather than the injury, of the party who does not breach. Doctrinally, a party who breaches cannot sue for damages on the contract and thus cannot collect any benefit conferred by the breach. One might ask why this should be so. Such a suit surely would offend those who find it immoral for a person to profit from her broken promise. But efficient breach theory is amoral by nature. So the theory should, yet fails to, explain why the expectation remedy disallows damages for the party in breach. Put another way, those who analyze contract law from an economic perspective frequently note that expectation damages award the benefits of termination to the breaching party; indeed, it is this fact that endows a party with efficient incentives when she contemplates repudiation. When the breach injures no one, however, the surplus from breach does not belong entirely to the party in breach. The question becomes one of why not, or of whether the rule should be otherwise. The answers, it turns out, are not obvious.

Just as property rights analysis until recently overlooked the potential advantages of forced purchases as an alternative to traditional liability rules, contracts analysis has overlooked the potential advantages of an award to the party in breach as part of the expectation remedy. Such an award may be analogized to a promisor's put option on the promisee's obligation to pay for the promisor's performance. The objective of this Article is to explore the potential benefits and costs of an award to the party in breach and to determine whether a justification for the current law exists within the framework of efficiency theory. In addition, the Article sheds new light on express contractual alternatives to expectation damages as well as on the mitigation doctrine.

Part I elaborates on contract doctrine's disallowance of an award to the party in breach, also referred to as negative damages, and identifies the prior literature. Part II describes more fully the theory of efficient breach. With the theoretical question thus presented, the remaining Parts explore the potential benefits, costs, and doctrinal implications of negative damages. Part III explores benefits of negative damages. It posits a case in which parties are fully informed about the consequences of contract termination, then relaxes the complete-information assumption and reveals that the allowance of negative damages could promote efficient breach decisions ex post as well as efficient investment decisions ex ante; other potential advantages to the allowance of negative damages are discussed as well. As Part IV demonstrates, however, Part III does not fully make the case for allowing negative damages, because such allowance could impose offsetting costs, most prominently from premature breach, costs that might be only partially mitigated by a rule allowing negative damages only where the party in breach would not otherwise have breached. Part V begins to explore doctrinal implications, describing impediments to express negative-damages clauses in contracts and identifying high-liquidated-damages and specific-performance clauses as means to ameliorate the disallowance of negative damages; the analysis thus provides a new argument for enforcement of such clauses. Part VI examines the mitigation doctrine in light of the law's disallowance of negative damages and defends the much-maligned weakness of the mitigation obligation as sensible in the absence of negative damages.

Ι

The Paradox of Negative Damages

Contract doctrine disallows negative damages, and this is consistent with the philosophical view of some commentators, who believe that one who breaches a contract acts badly. But the bad-actor approach to contract law does not generally carry the day, and so one wonders why this approach prevails with respect to negative damages. If philosophy does not fully explain the doctrine, one might expect economic analysis to do better, but to date it has not. This Part explores each of these observations as a prelude to the more complete economic analysis provided later in the Article. Philosophical and moral concerns are left to others.

A. The Doctrine: Negative Damages Are Unavailable

In United States ex rel. Coastal Steel Erectors, Inc. v. Algernon Blair, Inc., a construction subcontractor had partially performed under an agreement with the general contractor when the latter repudiated the contract and released the subcontractor from further performance.¹ The subcontractor invoked the doctrine of quantum meruit and claimed \$37,000 in restitution for the benefit it conferred on the general contractor, which had hired a substitute to complete the work that the subcontractor had begun.² The trial court awarded nothing on the subcontractor's restitution claim because, in the court's estimation, the subcontractor would have lost more than \$37,000 had it fully performed.³ An appeals court reversed and remanded: "'For it is an accepted principle of contract law, often applied in the case of construction contracts, that the promisee upon breach has the option to forego any suit on the contract and claim only the reasonable value of his performance.'"⁴

Though the case is couched in terms of quantum meruit, it also stands for the proposition that a party in breach of contract cannot claim damages on the contract. In the appellate opinion, quoting from a venerable article by Fuller and Purdue, the court addressed the plight of the general contractor, who might have benefited from the bargain that it repudiated:

[I]n suits for restitution there are many cases permitting the plaintiff to recover the value of benefits conferred on the defendant, even though this value exceeds that of the return performance promised by the defendant. In these cases it is no doubt felt that the defendant's breach should work a forfeiture of his right to retain the benefits of an advantageous bargain.⁵

Consider also the hoary case of *Bush v. Canfield*, in which the court encountered a defendant, like that in *Algernon Blair*, who breached his contract and then requested a reduction in the plaintiff's restitution award.⁶ The plaintiff was a buyer who had agreed to pay \$7 per barrel for flour and had given the seller a \$5000 deposit.⁷ At the time and place of anticipated delivery, the market price for flour was \$5.50.⁸ The seller was unable to deliver (or, in any case, did not deliver), and so the buyer sued for the return of the deposit, which the seller resisted on the ground that the failure of delivery enabled the

¹ 479 F.2d 638, 640 (4th Cir. 1973).

² Id.

³ *Id.*

⁴ *Id.* (quoting United States *ex rel.* Susi Contracting Co. v. Zara Contracting Co., 146 F.2d 606, 610 (2d Cir. 1944)).

⁵ Id. at 641 n.7 (citing Lon L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52, 77 (1936)).

⁶ Bush v. Canfield, 2 Conn. 485, 486 (1818).

⁷ Id. at 485.

⁸ Id. at 486.

buyer to obtain flour on the market at a lower price.⁹ The court ruled against the seller: "[I]t is not for him to say, that if he had fulfilled [the contract], the plaintiffs would have sustained a great loss, and that this ought to be deducted from the money advanced."¹⁰

Note that this doctrinal result is not limited to cases in which one party foolishly breaches the contract. A defendant might breach because performance has become prohibitively costly, yet try to defend against a restitution claim on the ground that the nonbreaching party would not have benefited from performance either. The doctrine plainly disallows this defense, whether or not the party who repudiates makes a rational choice. While the cases do not directly address a breaching party's affirmative claim to damages in the amount that the breach saved the nonbreaching party, it almost goes without saying that such a suit would fare no better than a defense against a restitution claim. The dearth of case law directly on point may merely be a testament to the fact that parties in breach are not brazen enough even to suggest affirmative recovery.¹¹

B. Philosophical or Moral Considerations

The doctrine seems straightforward, then. A party who breaches a contract breaks a promise and is in the wrong. She deserves no benefit from that contract. Some would defend this as a philosophical matter. David Hume described the material benefit to society of promise-keeping, but then added that "a sentiment of morals concurs with interest, and becomes a new obligation upon mankind."¹² More recently, Charles Fried said:

There exists a convention that defines the practice of promising and its entailments. This convention provides a way that a person may create expectations in others. By virtue of the basic Kantian principles of trust and respect, it is wrong to invoke that convention in order to make a promise, and then to break it.¹³

¹¹ There is some case law on point, at least with respect to the lease of real property. *See* Whitcomb v. Brant, 100 A. 175 (N.J. 1917) (holding that tenant who abandons lease cannot collect from landlord any excess over lease's rental rate when landlord relets).

¹³ CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGA-TIONS 17 (1981); cf. Richard Craswell, Contract Law, Default Rules, and the Philosophy of Promising, 88 MICH. L. REV. 489 (1989) ("[A]nalyses such as Fried's have little or no

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⁹ Id. at 487.

¹⁰ *Id.* at 488. The law does permit a party in breach to collect in restitution a benefit that it conferred, provided that the promisee is not thereby deprived of the benefit of its bargain. *See* RESTATEMENT (SECOND) OF CONTRACTS § 374 (1981). Collection is not permitted, however, for any savings the promisee garners as a result of its release from the contract.

 $^{^{12}}$ David Hume, A Treatise of Human Nature 523 (L.A. Selby-Bigge ed., 2d ed. 1978).

Such philosophy notwithstanding, Anglo-American contract law is essentially amoral, an observation closely associated with Oliver Wendell Holmes, who, more than one hundred years ago, said that "[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else."14 Holmes's statement has become the basis for an approach to contract law that allows a party to breach yet escape legal characterization as a wrongdoer.¹⁵ Such a party does not *break* a promise but rather exercises an option to fulfill one promise over another: the payment of damages, if any, rather than performance of the activity specified. As expressed by Justice Scalia: "Virtually every contract operates, not as a guarantee of particular future conduct, but as an assumption of liability in the event of nonperformance "¹⁶ Or, in the words of Judge Posner: "In Holmes's vivid formulation, the obligation created by a contract is an obligation to perform or pay damages for nonperformance, ... and if the second alternative remains, then, since it is an alternative, the obligation created by the contract is not impaired."¹⁷

The Holmesian account of contract obligation may be viewed narrowly as a statement that contract law is not punitive. There may be a moral content to promises, but this does not imply that a promisor's legal obligation to perform extends beyond financial remuneration. A promisor who chooses to pay damages rather than to perform may be seen as behaving badly, and the promisor may be shunned by others in the business community who expect performance.¹⁸ But if a sense of morality or a desire to protect reputation does not induce performance, then the law generally will not intercede or condemn the

¹⁶ United States v. Winstar Corp., 518 U.S. 839, 919 (1996) (Scalia, J., concurring) (referring to same Holmes quote).

¹⁷ Horwitz-Matthews, Inc. v. City of Chicago, 78 F.3d 1248, 1251 (7th Cir. 1996) (internal citation omitted).

¹⁸ See, e.g., Lisa Bernstein, Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry, 21 J. LEGAL STUD. 115, 138–43 (1992) (describing use of "reputation bonds" as alternative enforcement mechanism in diamond industry).

relevance to those parts of contract law that govern the proper remedies for breach, the conditions under which the promisor is excused from her duty to perform, or the additional obligations . . . imputed to the promisor as an implicit part of her promise.").

 $^{^{14}}$ O.W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897). This statement describes the general rule, not the exceptional case where specific performance is ordered.

¹⁵ Whether Holmes *meant* to suggest this is a matter of debate. *See* Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085 (2000) (arguing that common misreading of Holmes's statement is due primarily to opacity of his writing style). But neither Holmes's intent nor any inconsistency in the law's adherence to the principle is relevant to this Article. Rather, the Holmes quote, as it has been interpreted, reflects a school of thought that has not heretofore addressed the paradox of negative damages.

promisor. Hume and Fried perhaps would like it otherwise. Hume saw government itself as a means by which "men cure their natural weakness, and lay themselves under the necessity of observing the laws of justice and equity."¹⁹ But in its determination not to reprove those who breach, the law is generally with Holmes, not Hume.²⁰

The question arises, then: If the law generally does not characterize a party in breach as a wrongdoer, why is it that she cannot collect from a nonbreaching party who, vernacular aside, is a beneficiary rather than a victim of the breach? To be sure, there is a clear distinction between paying and collecting, and thus a damages floor of zero may be salient. Even so, it is not immediately clear what justifies such a floor. If the law did not revile the party in breach, one wonders why she should not collect, particularly inasmuch as collection can leave the party not in breach with the full benefit of his bargain. Consider, for example, a simplified version of *Bush*, where the seller breaches a contract for the sale of a single barrel of flour at a price of \$7 and the buyer covers-i.e., obtains substitute performance on the marketwith a \$5 purchase. The buyer could pay the seller \$2 and still receive her due, a barrel of flour for a total cost of \$7. Contract doctrine says the \$2 difference stays with the buyer, but it is not apparent why. Note that the law does not generally disfavor a benefit to the breaching party. Had the cover price been, say, \$8 instead of \$5, and had the seller breached because he could not access the market or otherwise supply a barrel of wheat for less than, say, \$10, the buyer would have collected \$1 in damages, enough to provide the benefit of her bargain but not more. The savings from the breach—here, the \$2 difference between the buyer's cover price and the seller's costwould be retained *entirely* by the breaching seller. So one wonders

¹⁹ HUME, *supra* note 12, at 537.

²⁰ This is not to say that the Humean position is necessarily correct even as a matter of morality. Some would argue that it is not. *See, e.g.*, Craswell, *supra* note 13 (arguing that philosophical theories are not necessarily relevant to aspects of contract law that address background rules); Steven Shavell, *Is Breach of Contract Immoral*?, 56 EMORY L.J. 439 (2006) (arguing that breach of contract should not be considered immoral because parties might not have required performance had they expressly addressed contingency at issue). The point here is merely this: There exists a plausible philosophical basis to characterize a breaching party as a wrongdoer, but outside the context of negative damages, the law—with some exceptions that are irrelevant here—does not adopt this characterization, preferring a morally neutral approach. For exceptions, such as in the method of damages calculation, see Oren Bar-Gill & Omri Ben-Shahar, *An Information Theory of Willful Breach*, 107 MICH. L. REV. (forthcoming June 2009) (on file with the *New York University Law Review*) (collecting sources). For the purposes of this Article, the observation that contract law is generally amoral sets the stage for a query as to whether there is an economic justification for the disallowance of negative damages.

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why the law allows a breaching party to retain, but not collect, the surplus from breach.

C. Negative Damages in Economic Theory

Consistency notwithstanding, it may be simply that moral outrage at broken promises becomes unbearable at the transition from positive to negative damages, even if there is little quantifiable difference between a party in breach who pays almost nothing and one who collects almost nothing. But it is unsatisfying to imagine that the law rests entirely on a vague salience of zero as the floor for a damages award, and one might look elsewhere for an explanation of why negative damages are not awarded. The Holmesian rejection of fault as a basis for contract remedy has led to a focus on economic efficiency as a basis for a damages award. Parties to a contract are treated as venturers in a joint enterprise, and remedy is addressed not as a tool for corrective justice but rather as a means to maximize the parties' joint welfare.²¹ Thus, economic analysis is a natural approach to the question of whether the law should provide for negative damages.

Yet the prior literature on the economics of negative damages is sparse and arises in a desultory set of narrow contexts. In the examination of the impossibility or impracticability doctrine, for example, Alan Sykes and Michelle White independently observed that negative damages might be an appropriate response to promisor risk aversion.²² In a signaling model, Hermalin and Katz described a potential role for negative damages where one party is unaware of the other's characteristics.²³ As part of a mechanism design, Aaron Edlin noted that negative damages would undermine an attempt to assign one party the breach decision.²⁴ In analyzing cover, Tom Jackson observed that where prices may fluctuate between breach and performance, an expected award is skewed by the truncation at zero of

²¹ See, e.g., 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) (describing nature of efficient breach).

²² Alan O. Sykes, *The Doctrine of Commercial Impracticability in a Second-Best World*, 19 J. LEGAL STUD. 43 (1990); Michelle J. White, *Contract Breach and Contract Discharge Due to Impossibility: A Unified Theory*, 17 J. LEGAL STUD. 353 (1988).

²³ Benjamin E. Hermalin & Michael L. Katz, Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach, 9 J.L. ECON. & ORG. 230, 247 (1993).

²⁴ Aaron S. Edlin, *Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages*, 12 J.L. ECON. & ORG. 98, 103–04 (1996); *cf.* Aaron S. Edlin & Stefan Reichelstein, *Holdups, Standard Breach Remedies, and Optimal Investment*, 86 AM. ECON. REV. 478 (1996) (discussing negotiation in shadow of specific-performance remedy as means to induce efficient investment).

the damages distribution.²⁵ In an examination of bankruptcy ipsofacto clauses. Che and Schwartz observed the same where a court must estimate damages.²⁶ In discussing restitution, George Cohen defended the implicit disallowance of negative damages as a means to dampen strategic behavior by a party who seeks to avoid the transactions cost of performance.²⁷ In separate discussions on promisee insecurity, Dick Craswell and Goetz and Scott considered whether a party may terminate a contract based on her counterparty's perceived inability to perform.²⁸ In a discussion of partial breach, where the victim does or should remain obligated to perform, Fon, Luppi, and Parisi considered whether either party might collect damages.²⁹ And within the context of the mitigation doctrine, MacIntosh and Frydenlund observed that the disallowance of negative damages can increase a promisee's post-breach risk incentive; in the same context, they also noted a connection between the disallowance of negative damages and the parties' breach decision-a connection explored below—but on this point did not offer substantial (or correct) analysis.³⁰ A goal of this Article is to begin a general economic analysis of efficient breach theory, one that for the first time integrates the concept of negative damages.

Π

EFFICIENT BREACH THEORY

Efficient breach theory is a cornerstone of the economic analysis of contract law. The theory begins with the observation, noted above, that the expectation damages remedy for breach requires a promisor to provide the promisee the full benefit of her bargain, but no more. This means, for example, that if a contractor agrees to paint a house for \$10,000 and then reneges, the contractor must pay the homeowner the difference between the value of performance and \$10,000. Sup-

²⁵ Thomas H. Jackson, "Anticipatory Repudiation" and the Temporal Element of Contract Law: An Economic Inquiry into Contract Damages in Cases of Prospective Nonperformance, 31 STAN. L. REV. 69 (1978).

²⁶ Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuation*, 15 J.L. ECON. & ORG. 441 (1999).

²⁷ George M. Cohen, *The Fault Lines in Contract Damages*, 80 VA. L. REV. 1225, 1345–48 (1994).

²⁸ Richard Craswell, *Insecurity, Repudiation, and Cure*, 19 J. LEGAL STUD. 399 (1990); Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967 (1983).

²⁹ Vincy Fon, Barbara Luppi & Francesco Parisi, *Optimal Remedies for Bilateral Contracts* 13–22 (Univ. of Minn. Law Sch. Legal Studies Research Paper Series, Paper No. 07-45, 2007), *available at* http://ssrn.com/abstract=1020669.

³⁰ Jeffrey G. MacIntosh & David C. Frydenlund, An Investment Approach to a Theory of Contract Mitigation, 37 U. TORONTO L.J. 113, 141–43, 148–53 (1987).

pose that the value of a paint job to the homeowner exceeds \$14,000, which is the amount the contractor's competitor would charge to do comparable work. The contractor would thus owe the homeowner \$4000.³¹ With that amount and the \$10,000 the homeowner had been bound to pay the contractor, the homeowner can hire the competitor and get what she expected from the initial contract: a painted house in exchange for (net) \$10,000.

Now consider the contractor's incentives at the time of the performance-or-breach decision. If, at that time, the contractor's cost of performance exceeds \$14,000, she will want to terminate the contract. She might not breach; she might instead seek a release from the homeowner. She might do this to satisfy a perceived moral obligation or to preserve her reputation. If the homeowner is recalcitrant, however, the expectation remedy provides the contractor with an out, a payment of \$4000 in damages. If, at the time set for performance, the contractor's costs are less than \$14,000, then matters are simpler still. Whether motivated by moral obligation, a desire to protect reputation, or narrow self-interest, the contractor will perform, despite any loss on the contract she would incur if her costs exceed the \$10,000 contract price. Because \$14,000 is also the social value of performance, determined in this case by the cost of the competitor's work,³² the contractor's private incentive also assures an optimal performance-or-breach decision: Perform when it is efficient to do so, terminate otherwise. Thus, expectation damages can usefully induce a promisor to behave in a mutually beneficial fashion even where the parties cannot fully specify such behavior in advance, an observation made early on by Steve Shavell.33

As an alternative, the law might simply hold the promisor to her bargain and rely on a negotiated release where termination is efficient. Thus, suppose that in the above illustration a court ordered the contractor to perform—an order of "specific performance"—or, as the functional equivalent, set the damages for the contractor's breach at a punitive level, say, \$10,000, while the contractor's cost of performance is \$18,000. In this case, if the contractor performed, it would suffer an \$8000 loss. But the parties might renegotiate instead and could settle on an amount that the contractor would pay the home-

³¹ This calculation implicitly incorporates the promisee's duty to mitigate, discussed in Part VI, *infra*.

³² For simplicity, assume that the market for a painter's services is competitive and that the price of substitute performance also reflects its social value.

³³ Steven Shavell, *Damages Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980); *cf.* RICHARD A. POSNER, THE ECONOMIC ANALYSIS OF LAW 56–57 (1972) (noting promisor's benefit).

owner for a release, an amount between the \$4000 the homeowner would lose if he had to hire another house painter and the \$8000 the contractor would lose from performance. (Assume that while the contractor's competitor would do comparable work, the work would not be identical and the contractor, therefore, could not unilaterally substitute the competitor's performance for its own.)³⁴ The result would be an efficient termination of the contract. An analogous illustration easily could show how renegotiation might prevent inefficient termination of the contract were the damages award set too low to induce the contractor's performance even if the contractor, rather than its competitor, could more cheaply do the work. Still, where the parties behave in a narrowly self-interested fashion, as some will at least some of the time, these results could be achieved only after negotiation and without a settled expectation of the outcome, which could range across the entire surplus generated by an efficient resolution. The cost of negotiation over a surplus is obviated under expectation damages, because the law sets what the victim of breach will receive at a level that gives the promisor an incentive to terminate unilaterally when it is efficient to do so; there is nothing to bargain over.³⁵ Expectation damages may lead to litigation, of course, but frequently will not, at least where the parties know or can fairly well estimate the outcome in advance. Thus, as compared to expectation damages, the costs of protracted negotiation count against specific performance or a damages rule that is punitive or undercompensatory.³⁶

In this latter illustration, the parties might have addressed the performance-or-termination decision in a different way, relying on neither expectation damages nor negotiated settlement. They might have specified that the contractor would be obligated to perform if and only if its realized costs were less than the market rate for comparable work, here \$14,000; they then could have allocated between them the risk of a cost increase that would excuse performance and

³⁴ Where there is a thick market for performance, the distinctions among a penalty, specific performance, and expectation damages fade, as a promisor can substitute a competitor's performance and not breach the contract at all. *See* Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 286–87 (1979) (describing circumstances in which breaching seller can cover as easily as buyer); *cf. infra* note 61 (discussing situation in which promisor cannot provide perfect substitution).

³⁵ *But see* Craswell, *supra* note 28, at 409–10 (observing that where information about cost and benefit of performance is asymmetric, parties would engage in contested negotiation even under expectation remedy).

³⁶ But see, e.g., John A. Sebert, Jr., *Punitive and Nonpecuniary Damages in Actions Based upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565 (1986) (arguing that there is substantial risk of error in calculating damages, which also tend to be undercompensatory). The text describes an ideal remedy of expectation damages, not necessarily the remedy the courts adopt in practice.

could have adjusted the contract price accordingly.³⁷ But it may not be useful to specify an individual contractor's idiosyncratic costs as a basis for obligation, as these costs may be difficult to observe or to verify in a court.³⁸ Even so, one might imagine that the market price for contractor services is easily observable and stable enough that the parties presume the homeowner will be willing to pay that price. That is, the contractor's cost might be the only variable subject to significant uncertainty.³⁹ In this case, expectation damages induce efficient performance or breach, a decision motivated by the unverifiable contractor's cost, all while a court is never asked to verify such cost. This is the genius of expectation damages.⁴⁰

³⁹ In this illustration, one might quibble in principle with the conclusion that the homeowner's willingness to pay the competitor's price is fairly presumed. *Cf.* Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1287–88 (1980) (describing model of optimal damages that limits recovery based on promisee's benefit). Yet in practice, the cost of cover is a relatively uncontroversial basis for damages, with judicial and scholarly attention paid only to exceptional cases, those where the cost of cover would be excessive except to the most idiosyncratic promisee. *See, e.g.*, Ian Ayres & Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. PA. L. REV. 45 (1999) (discussing cases in which promisee seeks specific performance order because she wants to sell it as court-ordered right to promisor); *cf.* Alan Schwartz & Robert E. Scott, *Market Damages, Efficient Contracting and the Economic Waste Fallacy*, 108 COLUM. L. REV. (forthcoming Nov. 2008), *available at* http://ssrn. com/abstract=1136156 (describing overcompensation concern as overstated).

In any case, suffice it to say here that the expectation remedy in this illustration requires less information than would a remedy that depended, in addition, on the promisor's cost. A scenario that depended additionally on a promisor's cost could arise where a court first had to determine whether such cost exceeded the market rate for the promised performance, then, if the answer to that question were no, also had to determine the injury to the promisee. A remedy based on the promisor's cost *instead* of the promisee's benefit, such as one proposed by Richard Brooks, would require different rather than greater information. Brooks would permit the victim of breach to elect between specific performance and a disgorgement remedy, where the victim's damages would be measured by the difference between the contract price and the promisor's cost. He argues persuasively that this remedy, like expectation damages, would yield efficient performance-or-termination decisions. Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 YALE L.J. 568, 584–86 (2006). However, the distinction between Brooks's proposal and expectation damages is inapposite to the discussion here.

⁴⁰ Not all would agree that expectation damages are genius. Scott and Triantis, for example, have argued that in thin-market settings parties should be encouraged to contract

³⁷ Relative risk aversion would determine how the parties would allocate risk, but the effects of risk aversion are beyond the scope of this Article.

³⁸ A recent literature has developed on how parties might shape their contractual obligations given the difficulty of verification. *See, e.g.*, Albert Choi & George Triantis, *Completing Contracts in the Shadow of Costly Verification*, 37 J. LEGAL STUD. 503, 520–23 (2008) (arguing that parties sometimes intentionally include difficult-to-verify terms and incur potential for costly litigation as signal or in order to enhance promisor's performance incentives). Such analysis is beyond the scope of this Article. Suffice it to say here that parties will not always prefer difficult-to-verify terms. *Cf.* Barry E. Adler, Avarice-Based Forfeiture (2007) (unpublished manuscript, on file with author) (arguing that difficult-to-verify terms may yield costly pooling of heterogeneous party types).

There is another potential advantage to expectation damages, one that looks back in time before the performance-or-termination decision. In the above illustration, imagine that the (risk-neutral)⁴¹ contractor's expected cost at the time of performance is a stochastic variable, the distribution of which the contractor can affect in advance with an investment, such as in the employment of a skilled manager. The contractor's private incentive to so invest depends in part on the damages it would be forced to pay should a high-cost realization make performance inefficient. Where the value of promised performance is \$14,000 and the contract price is \$10,000, the socially optimal investment is one that reflects a \$4000 damages award—the homeowner's true loss from breach. If the contractor instead anticipated, say, a negotiated payment of between \$4000 and \$8000, it would overinvest. Similarly, if the anticipated award were an amount below true cost, the contractor would underinvest in precaution compared to the social optimum. These costs of deviation from the expectation remedy would be borne by the parties jointly, regardless of how a price adjustment allocates the loss ex ante and regardless of whether renegotiation yields an efficient breach decision ex post.

This is not to say that expectation damages always yield ideal results. They do not. Where parties invest in a contractual project, as did the contractor in the above illustration, expectation damages may yield too much investment, at least where each party is able to pay any damages award against it. This is because where each party expects fully compensatory damages from breach, each invests without regard to the possibility that the other party might breach, as the other will either perform or pay for its failure to do so.⁴² Consequently, each party has an incentive to invest heavily in the potential benefits of a project or in precaution to avoid a breach that would make the party liable to its counterparty for such benefits. The socially optimal investment, by contrast, would cause each party to discount its own

around expectation damages to achieve efficient risk allocations. Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428 (2004). For reasons given in that article, though, parties might expressly contract for expectation damages even if they were not the default. The matter is not discussed further here.

⁴¹ For the sake of simplicity, here and hereafter, all parties are assumed to be risk neutral. The passage of time and the time value of money are also ignored. None of these assumptions drive any conclusion presented here.

⁴² As suggested above in the text, if there is a risk of promisor insolvency, this result will not hold. *See* Steven Shavell, *The Judgment Proof Problem*, 6 INT'L. REV. L. & ECON. 45, 45 (1986) ("An injurer will treat liability that exceeds his assets as imposing an effective financial penalty only equal to his assets"); *see also* Craswell, *supra* note 28, at 408–09 (noting that in cases of promisor insolvency, "incentives to terminate would not be optimal"). For simplicity, this complication is ignored here.

investment based on the possibility that the project might be abandoned efficiently. The parties may contractually predetermine (or "liquidate") moderate damages in order to separate the breach remedy from actual investment and thus cure the overinvestment incentive. Liquidated damages, however, can create their own inefficiencies, such as perverse incentives to breach ex post when the realized costs and benefits of performance differ from expectations at the time of contract.⁴³

Theories on the overinvestment incentive of expectation damages, the stochastic nature of cost, and the role of liquidated damages have usefully been pioneered or refined by Shavell,⁴⁴ Craswell,⁴⁵ Triantis and Triantis,⁴⁶ Cooter,⁴⁷ and Goetz and Scott,⁴⁸ among others. Theoretical qualifications and refinements aside,⁴⁹ however, expectation damages are both the doctrinal norm and a tolerably proficient mechanism for encouraging efficient breach and investment decisions.

⁴⁵ See, e.g., Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988) (emphasizing risk allocation and precautionary incentive effects of damages remedies).

⁴⁶ See, e.g., Alexander J. Triantis & George G. Triantis, *Timing Problems in Contract Breach Decisions*, 41 J.L. & ECON. 163 (1998) (arguing that expectation damages neglects inherent option value of contracts and may lead promisors to repudiate executory contracts earlier than is socially optimal).

⁴⁷ See, e.g., Robert D. Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 CAL. L. REV. 1 (1985) (discussing precautionary incentive effects of various damages rules).

⁴⁸ See, e.g., Goetz & Scott, *supra* note 21 (describing efficiency characteristics of liquidated damages).

⁴³ See, e.g., Kenneth W. Clarkson, Roger L. Miller & Timothy J. Muris, *Liquidated Damages v. Penalties: Sense or Nonsense*?, 1978 WIS. L. REV. 351, 368–72 (discussing circumstances in which liquidated damages may induce inefficient breach); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 581 (1981) ("Damage clauses stipulating an amount that exceeds the actual damages create an incentive to engage in opportunistic behavior.").

⁴⁴ See, e.g., Shavell, *supra* note 33, at 470–71 (discussing role of damages measures in inducing efficient incentives in various circumstances, such as where reliance affects damages measure).

⁴⁹ Though the text may suggest otherwise, not all qualifications yield the conclusion that the expectation remedy tends to produce excessive awards. Triantis and Triantis argue that expectation damages ignore the *promisee's* option to breach and thus yield undercompensatory damages and premature repudiation. Triantis & Triantis, *supra* note 46, at 165, 201. This result, however, depends in part on implicit and strong assumptions about the nature of current prices and the estimation of cost. *Cf.* Barry E. Adler, The Nature of Price and Cost as Determinants of Damages (2007) (unpublished manuscript, on file with author) (observing that, under some conditions, use of current price in calculation of damages can yield overcompensation). Moreover, not all theoretical refinements are limited to those mentioned in the text. For example, Edlin and Reichelstein show that where renegotiation costs are low and where one party's investment does not affect the return of the other, specific performance can achieve nearly ideal results. Edlin & Reichelstein, *supra* note 24, at 478 (1996). These qualifications and refinements are beyond the scope of this Article.

This is particularly so given that the law curbs the excesses of the expectation remedy with a variety of related doctrines, including those that disallow unforeseeable or speculative damages.⁵⁰ To date, however, efficient breach theory as described here has failed to account for the fact that expectation damages are awarded only when positive. An extension of the theory to address negative damages follows.

III

The Virtues of Negative Damages

As may be apparent from the theory of efficient breach, expectation damages can induce the correct breach decisions if they permit the party in breach to capture the entire surplus from termination of the contractual project. In the house painter hypothetical described in Part II, for example, it would cost the contractor \$18,000 to perform while it would cost its competitor only \$14,000. The value of performance to the homeowner exceeded this amount. The contract price was \$10,000, and the damages the contractor owed to the homeowner for breach were \$4000. The social surplus from breach, therefore, was \$4000, which is also the amount the contractor saved when it breached and paid damages rather than performed. Expectation damages thus aligned the contractor's incentives with those of society and at the same time honored the homeowner's bargain. As a result, expectation damages yielded breach as a Pareto-superior alternative to performance.

Disallowance of negative damages breaks the connection between the promisor's private incentive and social welfare. This has been largely overlooked, perhaps because simple analysis assumes symmetric and complete information, conditions that existed in the house painter hypothetical but that do not pertain generally.

Consider the following illustrations, based loosely on *Algernon Blair*. In the initial set of illustrations, the promisor has private information or a unique opportunity to discover that performance is inefficient but, in the absence of negative damages, would benefit from performance nonetheless. In these illustrations, negative damages give the promisor an incentive to breach when breach is efficient, a

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⁵⁰ See, e.g., Hadley v. Baxendale, (1854) 156 Eng. Rep. 145 (Exch. Div.) (disallowing unforseeable damages); Chi. Coliseum Club v. Dempsey, 265 Ill. App. 542 (1932) (disallowing speculative damages). See generally Cohen, supra note 27 (arguing that law to some extent adopts fault-based theory of contract damages as opposed to strict liability for breach); Brooks, supra note 39 (observing that efficiency might be served as well with damages remedy that permitted award in excess of expectation damages provided that certain safeguards were in place, such as due compensation for promisor's efficient expenditures).

significant improvement where only the promisor knows that breach is efficient. The capacity of negative damages to promote efficiency in this setting is the central insight here, but not the only relevant observation. Thus, in a subsequent illustration, negative damages are revealed as a means to counter overcompensation that results from judicial estimation; in essence, negative damages would allow a promisor to benefit from judicial error as much as it might lose from such error. And in a final illustration, a party who wants out of a contract engages in strategic litigation over the question of whether there has been a breach and by whom, another outcome that negative damages would counter, in this case because it would become relatively unimportant who in fact breached.

A. Promisor Private Information

As a baseline for analysis of asymmetric information, consider a simple case of complete information. A contractor agrees to construct a landowner's building over a period of time for a specified price. As time passes, the contractor's prospective costs rise as the value of the landowner's use for the building declines, each change an observable result of market fluctuation. Each party recognizes the plight of the other, as would any court. Assume that the cost of completion exceeds the contract price, which in turn exceeds the value of completion to the landowner. There are no externalities. Under these circumstances, one or the other party will repudiate the contract and terminate the project.⁵¹ It does not matter whether the contractor or the landowner breaches. The result is the same in either case-efficient termination and, under the expectation remedy, no damages to either party. Thus, in this standard story of efficient breach, where both the parties who must make a termination decision and the courts possess complete information, efficiency theory offers no challenge to the disallowance of negative damages.

Matters change when one relaxes the assumption of symmetric, complete information. An efficient breach decision subject to expectation damages requires that a promisor know not only her own cost but also the promisee's benefit. Thus, as is commonly known, and as intimated in Part II, a party's ignorance of her counterparty's benefit can yield an inefficient breach decision. Not well understood is that the disallowance of negative damages exacerbates this problem where only one party knows that breach is efficient and that party will never-

 $^{^{51}}$ In a richer illustration, the decision to terminate would depend on the variance in costs and benefits as well as the cost of deferring the termination decision, none of which is described here, or needs to be, given the purposes of the illustration.

theless *benefit* from the contract. In essence, as the Appendix sets out formally, the disallowance of negative damages may force a promisor to externalize the benefit created by her decision to terminate a contract and can, therefore, leave the promisor with insufficient incentive to breach. Thus, where the promisor has private information, neither party may breach even where termination of the contract is efficient. Significantly, where negative damages are disallowed, inefficient performance may occur in the plausible and stubborn circumstance that a party's private information is limited to its own cost, with information about the other party's benefit symmetric and complete.⁵²

1. No-Cover Termination Under Promisor Private Information

Another version of the contractor illustration may clarify:

Illustration 3A-1. A contractor agrees to construct a landowner's building over a period of time in exchange for \$20 million. As time passes and work begins, there is an industrywide influx of construction inputs, and the general market for contractor services shifts so that the landowner now could obtain comparable substitute performance to complete the building for \$15 million. But the landowner would also suffer a \$2 million dislocation cost from delay that would result in the switch, as a new contractor could not redeploy immediately and would have to learn the job specifications. The increase in supply for construction inputs also corresponds with a general recession, and the value of the building project to the landowner has declined to \$16 million. In addition to these commonly known circumstances, unbeknownst to the landowner, the contractor has suffered an internal management crisis that has increased its prospective cost of production relative to that of its competitors. Consequently, it would now cost the contractor \$18 million to complete the project.

In this illustration, termination is efficient because it would cost the contractor \$18 million to provide a building worth \$16 million, and if the contractor were replaced, the total cost of construction would be \$17 million (including the dislocation cost); the project should be abandoned.⁵³ Yet under expectation damages and the disallowance of negative damages, it may be that neither party will terminate. The contractor will not repudiate unilaterally because while it would pay

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⁵² In a discussion of mitigation doctrine, MacIntosh and Frydenlund, *supra* note 30, at 141–43, note the potential for information asymmetry to yield inefficient breach decisions where negative damages are disallowed, but their focus is on the situation where a promisor has superior information about a promisee's mitigation opportunity, a situation they themselves recognize as highly unlikely.

⁵³ But see supra note 51 (noting other possible factors for termination not considered here).

no damages, neither would it collect any. The alternative for the contractor is to perform and earn a \$2 million prospective profit. If the landowner believes that the contractor is typical—and by hypothesis, it has no reason to assume otherwise-then the landowner will not repudiate because if it did, it would expect to pay damages of \$5 million.⁵⁴ The alternative is to pay the \$20 million contract price for a building worth \$16 million and lose \$4 million. Were negative damages allowed, however, the contractor would repudiate the contract and collect \$4 million from the landowner, the difference between the contract price and the value of performance, an amount that corresponds with the contractor's \$2 million expected profit at the time of repudiation and the \$2 million surplus from contract termination. Moreover, just as in the case of positive damages, a court would need to determine only the landowner's benefit, not the contractor's cost. Thus, without putting special demands on the judicial system, allowance of negative damages-in essence, a promisor's put option on the promisee's obligation⁵⁵—would harness the promisor's private information.⁵⁶ The disallowance of negative damages is thereby shown to do harm.

Despite the foregoing, the parties might negotiate for efficient termination even where negative damages are disallowed. The landowner could, for example, attempt to induce termination with a blind offer to pay the contractor for cancellation of the contract on the *chance* that the contractor is idiosyncratic and performance is thus inefficient. In this illustration, there is a range for agreement between \$2 million and \$4 million, and one might suppose that the landowner would offer just under \$4 million before it allowed the project to go forward. But without information about the contractor's true costs,

⁵⁴ In a richer illustration, the expected damages would be stochastic, and the landowner would not assume with certainty that the contractor is typical. Consequently, disallowance of negative damages would be at work in the damages calculation as well, perhaps to increase the expected damages from repudiation because the landowner would treat the contractor's costs as a distribution centered on or near \$15 million, with damages increasing dollar for dollar with the reduction of costs between \$15 million and \$0 but decreasing for costs only up to \$20 million. Part III.B, *infra*, further discusses the truncation effect when negative damages are disallowed. For simplicity, it is assumed here that the court would accurately assess damages and that the landowner assumes with certainty that the contractor is typical.

⁵⁵ See Brooks, supra note 39, at 577 (describing put option as part of promisee election of remedy); cf. IAN AYRES, OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS 13–18 (2005) (describing implicit put options in law).

⁵⁶ *Cf.* AYRES, *supra* note 55, at 96–98 (contemplating form of truncated auction, where promisee can, through offer of supplemental payment for performance, increase damages paid by promisor in case of promisor's breach—thus not negative damages—and observing that such auction can harness promisee's private information, where such information exists).

the landowner's initial offer or offers could be out of range or aggressively low within the range. Either could lead to bargaining expense or breakdown, as a narrowly self-interested contractor might require, or simply hold out for, a greater amount and continue to work in the meantime.⁵⁷ In this setting, moreover, information asymmetry could be difficult to overcome. The contractor would not readily reveal its true cost because, armed with information of what would be a sufficient offer, the landowner might not negotiate at all but rather repudiate and reveal to the court the contractor's cost.⁵⁸ If successful, the landowner would pay damages of only \$2 million, and it can do no better in negotiation.⁵⁹ If the contractor could make its cost observable to the landowner but not verifiable to a court, immediate repudiation would not necessarily follow the contractor's cost revelation.⁶⁰ Still, the contractor would have a strategic incentive to pretend lower-than-actual cost, and bargaining would suffer accordingly.

2. Cover Termination Under Promisor Private Information

Variants of this illustration yield similar observations of forgone efficient breach:

Illustration 3A-2. A contractor agrees to construct a landowner's building over a period of time in exchange for \$20 million. As time passes and work begins, there is an industrywide influx of construction inputs, and the general market for contractor services shifts so that the landowner now could obtain comparable substitute performance to complete the building for \$15 million. In this version of the illustration, unlike Illustration 3A-1, the building project remains highly valuable to the landowner. If the contractor and landowner terminated their relationship, the landowner would replace the contractor with a competitor at the going rate for the work, but would also suffer a \$1

⁵⁷ It is well established that bilateral monopoly negotiation can be costly where information is asymmetric. *See, e.g.*, ROBERT GIBBONS, GAME THEORY FOR APPLIED ECONO-MISTS 218–24 (1992) (considering such costs in context of wage bargaining between firm and union).

⁵⁸ See Goetz & Scott, *supra* note 28, at 983 ("Parties will hesitate to trade information necessary for readjustments if bargaining over such transfers may itself alert the potential buyer to all or part of the very information that one might wish to 'sell.'"); *cf.* MacIntosh & Frydenlund, *supra* note 30, at 116–17 (describing negotiations over mitigation opportunity in absence of mitigation obligation).

⁵⁹ Matters would not change significantly if the landowner prepaid for the building, as even a party in breach can collect in restitution so long as such collection does not deprive the promisor of the benefit of its bargain. *See supra* note 10 and accompanying text (citing RESTATEMENT (SECOND) OF CONTRACTS § 374 (1981)).

⁶⁰ The prospect of information revelation without immediate repudiation is discussed more fully in Parts V and VI, *infra*, in connection with express damages and the mitigation obligation.

million dislocation cost from delay that would result from the switch. If the contractor unilaterally abandoned the project but tendered the work of a competitor, imposition of the dislocation cost would constitute a breach of the contract.⁶¹ Unbeknownst to the landowner, as before, the contractor has suffered an internal management crisis that has increased its prospective cost of production relative to that of its competitors. Consequently, it would now cost the contractor \$18 million to complete the project.

In this illustration, as in Illustration 3A-1, termination is efficient, here because a competitor can construct the building for \$3 million less than it would cost the contractor at a dislocation cost of only \$1 million.⁶² Yet under expectation damages and the disallowance of negative damages, it may be that neither party will terminate. The contractor will not repudiate unilaterally because, while it would pay no damages, neither would it collect any, as before. The alternative for the contractor, again, is to perform and earn a \$2 million prospective profit. If the landowner assumes that the contractor is typical and again, by hypothesis, it has no reason to assume otherwise-then the landowner will not repudiate, because if it did, it would expect to pay damages of \$5 million and suffer the \$1 million dislocation cost, each in addition to the \$15 million for the cost of completion by another contractor, for a total cost of \$21 million.⁶³ The alternative is to pay the \$20 million contract price. Were negative damages allowed, however, the contractor would repudiate the contract and collect \$4 million from the landowner, which is the difference between the \$20 million contract price and the landowner's \$16 million cost of completion with a substitute contractor. Consequently, the disallowance of negative damages once more causes harm. Again, the parties might renegotiate, but just as in the prior illustration, renegotiation would be

⁶¹ This is a pivotal assumption in this version of the illustration, one suggested in note 34, *supra*. If the contractor could itself hire a competitor to do the work and keep the landowner bound to perform in return, the problem addressed by this illustration would vanish. The assumption is not strong, however, at least not universally so. As discussed more fully in Part III.C, *infra*, a breach such as the imposition of a dislocation expense in this illustration—perhaps for failure to meet a progress schedule—may be considered material and thus release a promisee from its contractual obligations. *See* RESTATEMENT (SECOND) OF CONTRACTS § 241 (1981) (describing circumstances for "determining whether a failure to render or to offer performance is material"). Moreover, it is sometimes the case that the mere *identity* of a substitute performer will constitute a breach if attempted unilaterally by the promisor, as in the case of a personal services contract or a government procurement contract, among others, even where the promisor is a corporate entity. *See, e.g.*, 41 U.S.C. § 15 (2000) (government contracts); Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 492–93 (1st Cir. 1997) (patent license).

 ⁶² But see supra note 51 (describing other factors in decision to terminate efficiently).
⁶³ But see supra note 54 (describing scenario in which landowner does not assume with

plagued by information asymmetry, as the contractor would not reveal its true cost, or the landowner would exploit such information through immediate repudiation and a payment to the contractor of only \$2 million.⁶⁴

3. Promisor Investment in Search

A further modification of these contractor illustrations reveals that there is potential for the disallowance of negative damages to create another sort of inefficiency, one in ex ante search incentives:

Illustration 3A-3. Assume, as before, that a contractor agrees to construct a landowner's building over a period of time in exchange for \$20 million. Again, as time passes and work begins, there is an industrywide influx of construction inputs, and the general market for contractor services shifts so that the landowner now could obtain comparable performance to complete the building for \$15 million. As in Illustration 3A-2, the building project remains highly valuable to the landowner, so if the contractor and landowner terminated their relationship, the landowner would replace the contractor with a competitor at the going rate for the work but would also suffer a \$1 million dislocation cost from the resulting delay. Now, however, assume that although the contractor would benefit like its competitors from the influx of construction inputs, unbeknownst to the landowner, the contractor has a unique opportunity to pursue an alternative construction project that it alone could affordably complete. The proprietor of the alternative project would pay the contractor \$18 million; the new project would cost the contractor \$15 million, the same cost as the original contractual project.65 However, the contractor lacks the

⁶⁴ The parties might have contracted ex ante so that the contractor could unilaterally substitute performance of a competitor despite what the default rule would consider a material breach. *See supra* note 61 (describing scenario in which contractor could itself hire competitor to do work and keep landowner bound to perform in return). However, the parties would not be confident ex ante that this provision would be invoked only where it would be efficient.

⁶⁵ In this illustration, for simplicity, the benefit and cost to the contractor of the alternative project is given as fixed, and the focus is on whether that project will be pursued. In a richer illustration, one might imagine that the contractor would have post-breach discretion on how to invest resources in an alternative project. Such discretion would not matter in the current illustration but might in a different context. Assume, for example, that a promisor repudiated its contract with a promisee who was thus obliged to mitigate. In this setting, as observed by MacIntosh and Frydenlund, *supra* note 30, at 148–51, the promisee might have an inefficient incentive to increase the risk of its mitigation opportunity, because under an ex post calculation of damages mitigation, and in the absence of negative damages, the promisee would garner benefits from a highly successful project but not bear the cost of a failure. As MacIntosh and Frydenlund argue, an award of negative damages to the promisor could reduce the promisee's risk incentive, as the promisor would be awarded the gains from a success, but this is not an inherent virtue of negative damages, as

capacity to complete both the new project and the contractual project. It would be costly for the contractor to pursue the new project; the more it invests in this pursuit, in what I will call search (which it alone can do), the greater the likelihood it will obtain the new project.

This illustration matches Illustration 3A-2 except that the contractor's prospective cost of performance now includes a stochastic opportunity cost with a value that is a function of investment in search. It quickly becomes apparent that the contractor will not only forgo an efficient breach opportunity, if one is presented here, but will also underinvest in search.⁶⁶ Assume provisionally that ex post renegotiation on the original contract is prohibitively costly. To see why performance of the contract is certain under this assumption, observe that, as before, the landowner would expect to pay \$21 million if it repudiated-the \$15 million market rate for the work plus \$5 million in damages and \$1 million in dislocation cost-and would prefer to pay the \$20 million contract price instead. Observe also, as before, that the contractor will not repudiate if negative damages are disallowed, even in the presence of the alternative opportunity. If the contractor performs on the contract, then it will earn a \$5 million prospective profit; this amount is the contract price less the contractor's prospective costs, which here are common with its competitors' costs. If the contractor repudiated instead, then it could earn \$3 million from the alternative job—\$18 million for the work less the \$15 million cost of performance-and, as before, neither pay nor collect damages on the breached contract.⁶⁷ Because the contractor would not take the alternative project in any case, it will invest nothing in search. This is inefficient compared to search for and exploitation of the alternative project, which is socially desirable: It presumably yields at least \$18 million of value-the price the alternative project owner is willing to pay—at a social cost of \$16 million, comprising the \$15 million that would be spent by the contractor's competitor on the original project once the contractor's services are diverted plus \$1 million in dislocation cost from the switch of contractors.

Were negative damages permitted, the contractor would efficiently repudiate its initial contract if presented with the alternative project. After repudiation, the contractor would collect \$4 million

an ex ante calculation of damages mitigation—one that is not dependent on the mitigation opportunity actually pursued—would also address the perverse risk incentive, a point also made by MacIntosh and Frydenlund.

⁶⁶ Were both parties in a position to search, the aggregate level of search could be excessive, a point discussed *infra* in note 89 and accompanying text.

⁶⁷ *Cf. supra* note 64 (describing possibility of and limitations on unilateral substitution of performance).

from the landowner—\$5 million saved in cover less the \$1 million dislocation cost—and earn \$3 million on the alternative project, a total that corresponds with its \$5 million expected profit on the initial contract and the \$2 million social surplus from the alternative project. Moreover, because the contractor would realize the entire surplus from the alternative project, it would have a socially optimal incentive to search for the project.

The disallowance of negative damages is less harmful here if renegotiation is possible. But the contractor's underinvestment in search will persist here even if the parties could, without transactions cost, renegotiate for an efficient outcome ex post should the alternative opportunity materialize. This is so because even if the landowner could be counted on to negotiate rather than repudiate upon knowledge of the contractor's realized alternative opportunity, the parties can be expected to divide the social surplus from such opportunity. Consequently, ex ante, the contractor will expect to gain not \$2 million if the opportunity arises but rather some fraction of that amount. Because it bears the full cost of search, though, it will invest less than is socially optimal.⁶⁸ Again, the disallowance of negative damages is shown to be costly, here perhaps counterintuitively, because a promisor might not seek to *increase* its cost of performance where it alone has an opportunity to do so.⁶⁹

The search incentive point can be generalized further to a case in which the alternative project is lucrative enough to induce contractor breach, even in the absence of negative damages. In such a case, the contractor would have some incentive to search for the alternative project, even without the prospect of renegotiation. But that incentive would be suboptimal in the absence of negative damages because the forgone profit on the contractual project would operate as a tax on the benefits from the new project.

These observations about search, moreover, extend the potential usefulness of negative damages beyond the circumstance of information asymmetry at the time of the performance-or-breach decision.

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⁶⁸ This is a standard result. *See, e.g.*, Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 679 (2007) ("[A party] who anticipated not being able to appropriate the full value from her investment in a project would underinvest").

⁶⁹ As a conceptual matter, the disallowance of negative damages could remain, and expectation damages could be modified merely to permit compensation for reasonable investment in creation of the opportunity for efficient breach. *Cf.* Brooks, *supra* note 39, at 583–86 (arguing that victim of breach might efficiently be entitled to disgorgement remedy reduced by promisor's reasonable expenditures). As described *supra* in Part II, however, the usefulness of expectation damages is premised on the observation that efficient levels of activity may be difficult to verify.

Even if the promisee would learn of the promisor's mitigation opportunity should it materialize, the promisor at least would have a chance to repudiate first and capture the benefit of the opportunity if negative damages were permitted. This chance could induce the uniquely suited promisor to invest in search to some extent, albeit not optimally.

4. Promisor Investment in Precaution

Finally, the foregoing illustrations can be reconsidered to highlight an additional way in which the disallowance of negative damages can be socially suboptimal. In the above illustrations, the contractor's cost of completion at the time of performance is exogenously determined. In a richer example, however, this cost can be, in part, a function of the contractor's ex ante investment in precaution. An investment in precaution-in increased monitoring, for example-can plausibly reduce the expected cost of completion at the time of performance. As has been shown above, the disallowance of negative damages expands the circumstances in which the contractor will perform and thus bear its realized cost of performance. Consequently, in the absence of negative damages, the contractor has an expanded ex ante incentive to invest in precaution, and because it is the prospect of inefficient performance that generates the extra incentive, the additional precaution is socially wasteful. Negative damages would permit the contractor to repudiate inefficient contracts and collect based on the landowner's avoided loss; the damages thus would be independent of the contractor's own realized cost. With negative damages, therefore, the contractor would have a beneficially reduced incentive to invest in precaution.⁷⁰ Although, as explained below in Part IV, negative damages can create an offsetting perverse investment incentive, the net result could be to lessen the general overinvestment incentive from expectation damages, discussed above in Part II.

B. Judicial Estimation of Damages

There are other sources of inefficiency that stem from the disallowance of negative damages. Consider a promisor who anticipates that the value of her performance to a promisee lies within a range that also includes the contract price. A court asked to award contract damages can only estimate this value rather than determine it precisely. Given such uncertainty, because the disallowance of negative

 $^{^{70}}$ Note that precaution can be modeled alternatively to minimize the probability of inadvertent breach. *See, e.g.*, Cooter, *supra* note 47, at 3 (describing precaution as means to "avoid breach"). Accidental breach is discussed *infra* in Part III.C.

damages truncates at zero the distribution of a damages award, the promisor's expected liability from repudiation is inflated above an unbiased estimate of the promisee's loss from termination. Rather than breach and pay this inflated expected amount, or bear the cost of a negotiated termination, the promisor might perform even if termination were efficient.

Another version of the construction contractor hypotheticals may clarify:

Illustration 3B. Assume that the contractor has agreed to construct a building for the landowner in exchange for \$20 million. At the time that the contractor must decide whether to perform, the cost of performance is \$21 million while the benefit to the landowner is negligibly above the contract price. Termination is thus efficient. Assume, though, that a court would need to estimate the benefit of performance. Imagine that the court will determine damages with a draw from a benefit distribution that includes the true value, \$20 million, which has a 50% likelihood of selection, a low estimate of \$15 million, which has a 25% likelihood, and a high estimate of \$25 million, which also has a 25% likelihood. Where negative damages are disallowed, the contractor's expected liability for breach will be $0.25 \times (\$25 \text{ million} - \$20 \text{ million})$, or \$1.25 million, when the actual damages are approximately zero.71 As a result, even if risk neutral, the contractor has an incentive to perform and lose \$1 million, which here is also society's loss.⁷² Were negative damages permitted, by contrast, the possibility of an approximately \$5 million positive liability would be offset by an equally likely possibility of an approximately \$5 million negative liability, and the proper incentives would be restored.73

The ex post effects of a damages distribution truncated at zero have been observed elsewhere, by Jackson and by Che and Schwartz,

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 $^{^{71}}$ An "expected" value or liability is the product of that value or liability and its probability.

⁷² This illustration is stylized and ignores the variance in costs, as opposed to their estimation, between the time of repudiation and the time of performance. Triantis and Triantis, *supra* note 46, at 168–72, observe that cost variance may yield an offsetting tendency for undercompensation given current judicial implementation of the expectation remedy, which, according to Triantis and Triantis, fails to account for the promisee's own breach option. But even if this is so, the law could, in principle, correct both biases rather than allow them to compete as they will not always perfectly offset one another. *See supra* note 64.

⁷³ This conclusion is a simplification. As discussed in Part II, *supra*, and in Part IV, *infra*, expectation damages create a general tendency to overinvest in reliance and in precaution. Negative damages may generally exacerbate this problem, as discussed below, but with respect to overinvestment generated by judicial estimation, the effect is palliative.

for example, albeit in narrower contexts.⁷⁴ It is important, however, to stress the ex ante consequences as well. Anticipation of an excessive damages award can lead a promisor to overinvest in precaution. For example, in this illustration, the contractor might invest in preparation for the project, ordering and storing materials in advance to reduce the chance of a costly work interruption at the time of performance. How much the contractor would invest would depend on the consequences of a high-cost realization. Here the expost value of the project was little more than the contract price, and one might imagine that even at the time of contract, the expected value of the project did not greatly exceed the expected cost. The contractor's optimal investment in precaution would be correspondingly small, but the contractor will overinvest where it anticipates that breach would impose significant liability-here \$1.25 million-or perhaps the cost of negotiation in an attempt to settle on a lower amount even if the landowner is not injured.⁷⁵ This phenomenon exacerbates the overinvestment incentive generated by the fact that expectation damages reflect actual, rather than optimal, investment by the parties.⁷⁶

There is more. Some breach is stochastic (accidental) rather than deterministic (by repudiation).⁷⁷ Thus, one could plausibly consider an alternative model for the effect of precaution, one in which precaution reduces the probability of breach. Still, the disallowance of negative damages induces promisor overinvestment because the expected damages award would exceed actual damages. In this illustration, breach would in fact cost the landowner almost nothing, but the contractor would expect to pay damages of \$1.25 million. Therefore, the allowance of negative damages would restore proper incentives in this case as well.⁷⁸

C. Uncertain Breach

The discussion so far has implicitly assumed that a breach, if one occurs, is by repudiation—a total, singular event where the identity of the breaching party is certain. Breach is not always so easily defined,

⁷⁴ See supra notes 25–26 and accompanying text (describing both works); *cf. supra* note 65 (describing truncation in related context).

 $^{^{75}}$ Cf. supra note 57 and accompanying text (discussing effects of asymmetric information on negotiation costs).

⁷⁶ See supra notes 42–48 and accompanying text (explaining that under expectation damages, parties overinvest in contractual projects to increase return or avoid liability).

⁷⁷ *Cf.*, *e.g.*, Cooter, *supra* note 47, at 5–19 (analogizing contract to tort); Craswell, *supra* note 45, at 646–49 (same).

⁷⁸ See supra note 73 (observing that negative damages may exacerbate overinvestment in reliance and in precaution but may counter overinvestment generated by judicial estimation).

however. Consider a case in which a promisor fails to satisfy an early part of her contractual obligation or otherwise gives an indication of a pending breach, all while suffering financial difficulty that causes the promisee to fear that the promisor will be unable either to perform fully or to pay damages for this failure. As Dick Craswell has observed, in a situation such as this, the promisee's incentive to make a termination decision, while not ideal, may be better than the promisor's.⁷⁹ This is so because a premise of efficient breach theory is that a promisor internalizes the cost of a repudiation decision. An insolvent promisor will not do this. Therefore, if the promisee has information that allows it to make the proper decision, the law should perhaps provide the promisee with the incentive to breach efficiently; otherwise, the promisor might gamble-in essence, with the promisee's money—by continuing a project that should be terminated. The law, to some extent, provides this result through the related doctrines of material breach and adequate assurance of future performance.⁸⁰ If the promisor has materially breached a contract, or (at least under the Uniform Commercial Code) if the promisee otherwise has reason to be insecure about future performance-e.g., if the promisor has not provided adequate assurance of such performance—the promisee may terminate the contract and collect damages from the promisor. The promisee thus has a relatively robust incentive to terminate when it is efficient to do so.

The damages that a promisee can collect in this setting are not negative damages in the sense used here. This is because while the promisee can collect (to the extent of the promisor's solvency) its own lost profits from termination of the project, it cannot collect any savings bestowed on the promisor from the termination. Thus, although the doctrines of material breach and adequate assurance permit a party to make a termination decision yet collect damages, a better characterization of the result is an expansion of how the law defines promisor breach. Regardless of the terminology applied, these doc-

⁷⁹ Craswell, *supra* note 28, at 413–19 (describing circumstances, including possible sidepayment by promisor, under which promisee may have better incentive to make termination decision); *cf.* Goetz & Scott, *supra* note 28, at 990–91 (discussing inefficiencies from promisee insecurity).

⁸⁰ For the doctrine of material breach, see RESTATEMENT (SECOND) OF CONTRACTS § 241 (1981), which lists circumstances that determine whether failure to render performance is material. For the doctrine of adequate assurance, see U.C.C. § 2-609 (amended 2003), which provides that if reasonable insecurity of the other party's performance arises, a party may demand "adequate assurance," and the failure to provide such assurance within reasonable time constitutes repudiation of the contract. For related doctrines, see U.C.C. § 2-508, 2-612 (amended 2003), which allow the seller a right to cure or to provide adequate assurance of cure, respectively, for some nonconforming deliveries.

trines represent an attempt by the law to harness information that might be wasted unless the informed party has the incentive to act.

As discussed earlier in Part III.A, a more general permissibility of negative damages also would have this effect, but more broadly, and in the perhaps more common circumstance that the useful information is about the party's own affairs. There is, moreover, a more direct connection between the doctrines of material breach and adequate assurance, on the one hand, and a proposal for more liberal allowance of negative damages, on the other. The latter may reduce unintended consequences of the former. An illustration may clarify.

Consider the now-familiar construction-contractor hypothetical, this time featuring uncertain breach:

Illustration 3C. A contractor agrees to construct a landowner's building over a period of time in exchange for \$20 million. As the project progresses, the contractor recognizes that its cost of completion will be \$22 million, an amount that is \$2 million less than any competitor would charge to finish the project. Completion of the project is worth \$25 million to the landowner. Performance is efficient because the value of the contemplated project exceeds the project's cost, but the contractor would prefer to be relieved from its contractual obligation. A term of the contract requires that the landowner continually drain the building site so that there is no standing water during construction. The landowner drains the site periodically, but some water remains. A dispute arises as to the significance of the water.

The contractor claims that the landowner has materially breached the agreement and seeks termination. The landowner argues that the breach is minor and can be remedied by a trivial increase in the price paid for construction. If the breach is minor, or if the landowner will reliably pay any damages from its continuing failure to remove water, the contractor should remain bound. These determinations are difficult, however. The line between immaterial and material breach is not bright, and courts struggle over the distinction. Thus, a court might rule in favor of the contractor even if the landowner's breach is insubstantial and the contractor's grievance entirely strategic. As Goetz and Scott warned, the result could be termination of an efficient project or costly negotiation to prevent this outcome.⁸¹ Moreover, even if

⁸¹ Goetz & Scott, *supra* note 28, at 982–83; *see also* Craswell, *supra* note 28, at 416–18 (describing costs and benefits of renegotiation). For similar analyses in related contexts, 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), and Alan Schwartz, *Cure and Revocation for Quality Defects: The Utility of Bargains*, 16 B.C. INDUS. & COM. L. REV. 543 (1975).

the project is not terminated after a court finds a material breach, and even if renegotiation is costless, renegotiation would force the landowner to sacrifice some portion of its expected return from the contractual project. That is, in renegotiation, the landowner would expect to pay the contractor between its cost of \$22 million and its competitor's best price of \$24 million to complete the project when the contract price was only \$20 million. Ex ante, anticipation of such ex post renegotiation, which will occur with a positive probability, reduces the landowner's incentive to invest in reliance on the contractor's performance and increases the landowner's incentive to take precaution wastefully against trivial breaches, which can thus have nontrivial consequences.

Now assume that the law generally allowed negative damages. Then, in this illustration, if the court found the landowner's breach material, the landowner would nevertheless collect \$2 million in damages from the contractor, the loss that the contractor would have incurred were the contract performed. Craswell has argued that such a return would eliminate the contractor's strategic incentive,⁸² but here this would be an overstatement. Despite its liability for negative damages, the contractor might seek to terminate the contract because it anticipates renegotiation with the landowner where it will extract some portion of the \$2 million advantage it has over its competitors.83 Still, the loss to the landowner would be reduced as compared to the circumstance in which negative damages are disallowed, and thus the landowner would have a relatively stronger incentive to invest in reliance and a weaker incentive to invest wastefully in precaution against trivial breach. Moreover, the law could be amended not only to allow negative damages here but also, at least in principle, to prohibit renegotiation. In that case, the contractor would in fact have no incentive strategically to terminate the contract.84

The use of negative damages to combat strategic behavior in this setting may be too fine grained to be useful. As noted above in Part II, and discussed further below, the expectation remedy induces overinvestment in reliance. So it is conceivable that the risk of strategic termination is a useful mitigation of that incentive, one that balances

⁸² Craswell, *supra* note 28, at 419.

⁸³ *Cf.* Fon, Luppi & Parisi, *supra* note 29 (describing circumstances in which efficiency favors damages, not merely negative damages, for party in breach).

⁸⁴ Contractual prohibitions on renegotiation are often theoretically desirable but may prove difficult to enforce in practice. *See, e.g.*, Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2 (2000) (describing benefits of ban on renegotiation but noting that parties have incentive to ignore prohibitions to achieve ex post efficiency).

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the incentive for wasteful precaution induced by such risk, albeit roughly. Suffice it to say, though, that there are a number of potential advantages to the allowance of negative damages, advantages that the law and commentators have largely overlooked, perhaps because the concept itself seems absurd. The analysis in this Part has sought to dispel that impression and to prompt greater attention to the issue.

IV

The Vices of Negative Damages

The analysis above shows that the allowance of negative damages would have virtues. The case for allowance of negative damages is not made, however. Such allowance could impose offsetting transactions cost as well as costs in the form of perverse investment incentives, including premature repudiation of contractual projects. These potential costs are described and analyzed in this Part.

A. Transactions Cost

An initial point in this regard is straightforward. In some cases, even in the absence of negative damages, a promisor will terminate a contract from which neither party would benefit. Where negative damages are disallowed, the promisee might not seek a payment from the promisor. Even if she did, the promisor might simply refuse to pay, and in the subsequent litigation, a court would have to determine not the full extent of what the promisee would have lost under the contract but only that there would be a loss; any loss would imply an award of zero. Were negative damages allowed, however, every repudiation of a contract would entitle one party or the other to a payment dependent on the precise value of performance. Of course, this value is routinely relevant even in the absence of negative damages, as it is germane to every case in which expectation damages are positive. So the allowance of negative damages would not burden the parties or courts with an additional or novel fact to settle on or litigate over. Still, the allowance of negative damages would increase the number of cases in which a precise valuation is pertinent, and this would entail additional transactions cost.

This excess cost might be avoided if the law disallowed negative damages only where the promisor would have breached in any case. But to apply such a rule, the court would have to determine the promisor's costs, adding another sort of transactions cost not required by a general disallowance of negative damages.⁸⁵

⁸⁵ This point is discussed further in Part IV.B.2, *infra*.

B. Perverse Incentives

The positive incentives of negative damages, described in Part III, are not *uniformly* positive. Negative damages as a cure would have side effects in the form of perverse incentives that may, in part or in whole, offset the beneficial incentives. Given the possibility of negative damages, the promisor might sabotage the promisee or overinvest to avoid payment. In addition, the prospect of negative damages could cause the parties to withhold from one another information they might otherwise usefully share. These considerations, discussed in turn below, may be minor in significance. Potentially more important, however, is the prospect that negative damages will engender inefficient search or a costly repudiation race when the parties are symmetrically, rather than asymmetrically, informed; this Part concludes with an analysis of such a prospect.

1. Sabotage of the Promisee

Where the promisor can affect the value to the promisee of the promisor's performance or the cost of the promisee's performance, the promisor may succumb to a perverse incentive and sabotage the promisee. That is, the promisor may expend resources in an attempt to lower the value of the contract to the promisee, then breach and collect the fruits of its wasteful efforts. (A related strategic, and wasteful, practice would be for a sophisticated promisor to seek out naïve promisees who overestimate the value of performance, then terminate contracts with them.) A promisor may seldom have such an opportunity, though, and so this cost of negative damages might not generally be significant.

2. Overinvestment To Reduce Potential Negative Damages Payments

More broadly applicable, perhaps, is the observation that the allowance of negative damages may exacerbate the general tendency of expectation damages to induce ex ante overinvestment in the value of a contractual project, a tendency already noted. Efficiency requires a party to account for the fact that its investment will be wasted if its counterparty breaches. Disallowing negative damages discourages the excessive investment that occurs when a party does not internalize the prospect of the other party's breach, as the disallowance implies that the nonbreaching party will pay no damages regardless of how little it would have valued mutual performance. A change in the law that would permit negative damages would reverse this result and could encourage overinvestment by a promisor who sought to minimize any potential payment of negative damages. December 2008]

Consider, for example, a modified version of the *Algernon Blair* construction-contractor hypothetical from Part III, this time featuring a foreseeable probability of mutual loss:

Illustration 4B-1. A contractor agrees to construct a landowner's building over a period of time in exchange for \$20 million. At the time of contract, the parties anticipate the possibility of a universally observable exogenous event or set of exogenous events that would simultaneously reduce the value of the building to a range between \$18 million and \$20 million, depending on the landowner's prior investment in the project, and increase the contractor's cost of completion to a range between \$20 million and \$22 million, depending on the contractor's investment in precaution. If negative damages were allowed, anticipation of such an event or events would provide an incentive for wasteful investment by both parties. To see this, note that even where the value-reducing contingency is realized, the landowner would like the value of the building to be near \$20 million because if the contractor repudiated, the landowner's liability-equal to the excess of the contract price over the project's value-would decline as the value approached the contract price. Similarly, the contractor would like its cost to be near \$20 million because if the landowner repudiated, the contractor's liability-equal to the excess of its cost over the contract price-would decline as the cost approached the price.

This said, the exacerbation of the overinvestment incentive is not certain, because the incentive to overinvest induced by negative damages would have an offset. Just as the prospect that a party might pay negative damages gives it an incentive to inefficiently reduce its costs or increase its benefits, the prospect that the party might receive negative damages mitigates that inefficient incentive. To see this, note that in the absence of negative damages, the contractor in these construction illustrations profits only if its realized costs are below the contract price, and thus the contractor will want to reduce these costs even if it anticipates that the landowner will breach. As described above in Part III.A, however, were negative damages permitted, the contractor would anticipate the possibility that it would repudiate the contract and collect damages from the landowner based on the difference between the contract price and the value of performance to the landowner, not based on the contractor's own costs. And if the contractor repudiated, its investment in cost reduction would prove wasted; the prospect of such waste, in turn, would reduce the contractor's incentive to lower its cost. A parallel story can be told about the landowners' incentives, and thus negative damages will not unambiguously exacerbate the overinvestment incentive. Put simply, because breach

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damages are awarded based on the promisee's loss, in anticipation that the other party will breach, a party has an incentive to increase inefficiently its expected profits on the contract while there is no such incentive in anticipation of one's own breach. Because negative damages can increase the likelihood of a party's own breach as opposed to the other party's, negative damages could reduce a party's incentive to invest. Still, the prospect that there will be a net exacerbation of the overinvestment incentive may be counted as a potential cost of negative damages.

Wasteful investment induced by negative damages, if any, could be reduced if the law allowed negative damages only where performance otherwise would have occurred.86 In this illustration, where information is symmetric, whether the contractor or landowner repudiated, the other would have, with or without negative damages, and so a court could decline to award such damages; as a result, neither party would overinvest in anticipation of negative damages. However, a determination that a contract would have been performed but for negative damages could be difficult for a court even where a calculation of negative damages might be relatively easy. Consider, for example, the illustrations in Part III.A. There, when the contractor breached, a court could award negative damages, just as it could ordinary expectation damages, based only on the difference between the contract price and the value of performance. The court would not have to determine the contractor's costs, which might be difficult to verify. Were the value of performance itself difficult to measure, even straight-forward negative damages might be difficult to calculate, just as ordinary expectation damages would be, but a conditional award increases the information required for a correct determination.87 Consequently, allowance of negative damages subject to the condition that the contract would have been performed might be unworkable even where an unqualified allowance of negative damages could func-

⁸⁶ *Cf. supra* note 85 and accompanying text (addressing possibility of conditional negative damages). Compare Craswell's observation that an insecure party should be permitted to make a termination decision only if there would be no uncertainty about that party's willingness to perform but for its insecurity. Craswell, *supra* note 28, at 426. Also compare MacIntosh and Frydenlund, *supra* note 30, at 142–43, who discuss a limitation of negative damages to the case of asymmetric information, but analyze only the implausible circumstance in which a promisor has superior information about a promisee's mitigation opportunity.

⁸⁷ Part II, *supra*, explains the information requirements for expectation damages to work effectively. Also, in the illustrations provided in Part III.A, *supra*, the amount of negative damages would be reduced by the transactions cost of cover—described above as the dislocation cost caused by substitute performance—but this amount, while perhaps difficult to estimate, might not be substantial relative to the overall damages and, moreover, would not determine *whether* damages would be awarded at all.

tion. So it would claim too much to suggest that negative damages could be purely beneficial, a medicine with no side effects. (The same observation limits the usefulness of more exotic uses of negative damages, for example, where the surplus from breach might be split between the promisor and promisee, perhaps to balance the benefits and costs of negative damages discussed above and below.) Like the expectation remedy itself, negative damages are useful in some, but not all, settings.

3. Mutual Misinformation

This observation raises another set of concerns about the allowance of negative damages. The potential benefits of negative damages, discussed in Part III above, turn in part on the presence of asymmetric information, in particular where the promisor but not the promisee knows that termination is efficient. But sometimes information between the parties is differently asymmetric, and sometimes it is symmetric. In either circumstance, the allowance of negative damages could be inefficient.

Take, for example, a case in which a promisor and a promisee will each lose in the event that both sides perform, but each mistakenly believes that performance is efficient based on an erroneous estimation of the other's benefits and costs, respectively:

Illustration 4B-2. To demonstrate simply, assume a contract price of \$20 million, a contractor's cost of \$22 million, and a landowner's value of \$18 million, but assume that the landowner estimates the contractor's cost as \$17 million while the contractor estimates the landowner's benefit as \$23 million. In the absence of negative damages, each party would, if it could, freely disclose to the other the true nature of its circumstance as, for each party, the best possible outcome would be for the other to repudiate. Thus, an efficient termination may be likely. If negative damages were allowed, however, each party might withhold information that could cause the other to repudiate. Each party could then attempt to learn more about the other's circumstance in the hope that a revised estimate would allow it, rather than its counterparty, profitably to repudiate. Mutual misinformation of this sort may be less common than the one-sided asymmetry that favors the allowance of negative damages. Still, just as the disallowance of negative damages may sometimes yield inefficient performance or costly renegotiation, at other times so might the allowance of negative damages. In principle, the disallowance of negative damages only where either party might have collected such damages could eliminate the incentive to withhold information here. However, just as in the case where negative damages might be disallowed for a party

who would have breached in any event, administration of such a rule could prove difficult.

4. Inefficient Search and Premature Termination

Turn now to the assumption of symmetric information. Given this assumption, in the illustrations above, if the contractor's realized cost of completion exceeds the landowner's realized benefit, one party or the other will repudiate the contract regardless of whether negative damages are allowed; given the inefficiency of performance and a promisee's obligation to mitigate, one or both parties will have an incentive to terminate. If negative damages were allowed, there could be a race to repudiate because the first party to do so would collect the surplus from efficient termination. In this simple case, where information is both symmetric and complete, such a race may be costless.⁸⁸ Matters change, however, if one assumes that the cost or benefit of project completion is uncertain.

Assume, for example, that the contractor's direct costs of completion are below the landowner's benefit, which exceeds the contract price, but assume also that there is a chance that the contractor may have an alternative project, one that would raise its costs, including opportunity cost, to an amount above the landowner's benefit. Assume, however, that only search will reveal whether the contractor has this opportunity and that neither the contractor nor the landowner has an advantage over the other in search, perhaps because the contractor's skills are general. That is, assume that information is initially incomplete but symmetric. Under these assumptions, the disallowance of negative damages may reduce inefficient search. This is because, given such disallowance, the landowner could not unilaterally or easily profit from the discovery of the contractor's opportunity; were the landowner to bring the opportunity to the contractor's attention, the contractor could simply exploit it rather than negotiate. (Such exploitation, which the landowner would anticipate, would be analogous to the landowner's repudiation rather than negotiation described above in Part III.A.) As a result, absent negative damages, the contractor might search with little or no competition from the landowner. Were negative damages permitted, either party could

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⁸⁸ As discussed in Part III.A, *supra*, such a race may *not* be costless depending on the parties' investment incentives. *Cf.* Edlin, *supra* note 24, at 105 n.11 (noting that race to repudiate would undermine contract designed by parties to make repudiation by one party impossible, thus vesting in other any incentive to repudiate). As Edlin himself observes, such contracts are not uniformly useful, as they are less than ideal when it is efficient for both parties to invest in the contractual project. In any case, the discussion in the text is simplified to isolate focus.

benefit fully from repudiation of the contract upon discovery of the alternative project, and each might have a relatively strong incentive to search. This could be suboptimal, as competition for a benefit from search could lead to wasteful duplicative effort or perhaps costly negotiation to avoid such excess.⁸⁹

The same pattern would be presented if the contractor would profit from a contract despite an uncertain alternative project that would render contractual performance inefficient. In that case, in the absence of negative damages, the landowner would have an incentive to search for such a project so that it could repudiate the contract and force the contractor to mitigate, while the contractor could not benefit as easily from discovery of the project, which, by hypothesis, it would not unilaterally exploit. The allowance of negative damages, by contrast, would invest each party with an incentive to discover the project as the first to repudiate would gain the full benefit of termination and such incentive could be inefficient.

More significantly, perhaps, allowance of negative damages in this setting may yield premature termination where, in the face of uncertainty, the background information at the time of a decision suggests that termination is likely to be (but is not assuredly) efficient. In this situation, were negative damages permitted, each party might have an incentive to repudiate the contract immediately, even though a sole beneficiary of delay would investigate further or simply wait for uncertainty to resolve prior to any termination, despite the cost of such investigation or delay. That is, the contractor and landowner might inefficiently race to repudiate if the first to do so would capture the expected surplus from termination.

Consider the following version of the construction-contractor hypotheticals:

Illustration 4B-3. A risk-neutral contractor agrees to construct a risk-neutral landowner's building over a period of time in exchange for 20 million. The value of the building to the landowner is at all relevant times 22 million, and (for simplicity) no other contractor can do this work. At the time of contract, both parties anticipate that the contractor's cost of construction will be just under 20 million. Subse-

⁸⁹ A standard result in search models such as this is that a race produces too much search because no searcher internalizes the loss suffered by a rival. JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 396 (1988). It is possible to alter standard assumptions about the cost, utility, and timing of search by each of multiple parties such that multiple-party search becomes efficient. Suffice it to say here that such an outcome would not be assured. Cohen, *supra* note 27, at 1295, makes a similar point with the observation that a buyer and seller in a sales contract may compete to find a higher-value, third-party buyer. *Cf.* MacIntosh & Frydenlund, *supra* note 30, at 142 (noting benefits and costs from two-party search induced by negative damages).

quently, however, the contractor has an opportunity to bid on another project, one that would yield the contractor \$4 million in profit if its bid is accepted. (Alternatively, one might assume that there is a chance that the contractor's direct costs of completion will be \$24 million.) Both parties assess a 75% probability that the contractor can win this project, which it cannot complete while still performing on its contract with the landowner. (Or the parties assume that there is a 75% chance of a \$24 million realized cost of completion.) Assume that these values are verifiable to a court (as would sometimes be the case). Were negative damages permitted, the landowner would repudiate, given the chance. To see this, note that if the landowner did not repudiate, it would receive either performance or expectation damages, each worth \$2 million; if it repudiated, it would expect $0.75 \times ($4$ million), or \$3 million, which is at the time of repudiation the contractor's expected loss from performance.⁹⁰ In anticipation of this, the contractor would try to repudiate first, pay the landowner \$2 million in damages, and retain its expected \$3 million in profit from the alternative job (or avoid an expected direct loss in that amount). If repudiation terminated the project, though, the parties would forgo the 25% probability that performance rather than termination would have been in their mutual interest. The disallowance of negative damages eliminates the landowner's incentive to repudiate early and thus also eliminates the contractor's incentive to do so (even if delay in termination were somewhat costly).

The formality of repudiation would not necessarily mean that possibly efficient continuation would be forgone, because the parties might renegotiate after repudiation to postpone termination of the project until the realization of the project's true cost. But such negotiation itself could be costly. Moreover, as noted above, each party might inefficiently search from the time of contract formation for information that would put it in a position to recognize early any expected efficiency from termination. Such advanced notice would allow a party to repudiate first and thus establish the expected surplus from termination as its reservation price in the negotiation over continuation. Not even the prospect of costless renegotiation after repudiation would eliminate such wasteful investigation in anticipation of a race.

⁹⁰ For simplicity, the distinction between an ex ante and ex post calculation of damages is ignored. For a general discussion of this distinction, see Royce de R. Barondes, *An Alternative Paradigm for Valuing Breach of Registration Rights and Loss of Liquidity*, 39 U. RICH. L. REV. 627, 664, 668–73 (2005). *Cf. supra* Part III.B (noting consequences of price fluctuation between time of breach and performance and consequences of court-estimated damages).

The competition that would be inherent in the allowance of negative damages, then, could lead to too much search while continuation remained likely to be efficient and too little patience after efficient termination became more likely, a situation that could be remedied perhaps only through costly renegotiation, if at all. Because disallowance of negative damages can, at least in some instances, assign the benefits of search to a single party, disallowance may alleviate, rather than exacerbate, the problems of inefficient search and termination decisions. In particular, where information is likely to be symmetric, the disallowance of negative damages is most easily justified.

One might imagine that the law could invest the contractor with a unilateral right to repudiate and collect negative damages but deny the landowner the right to repudiate or force mitigation, whether or not the landowner would have breached absent the prospect of negative damages. This would invest the contractor with the only search incentive and would avoid the risk of a repudiation race. Such a rule would be consistent with contractual limits parties sometimes place on repudiation options, as discussed below in Part V. It is important to keep in mind, however, that these illustrations include the simplifying assumption that only the contractor, not the landowner, could be induced efficiently to repudiate by an award of negative damages. One could alter these illustrations so that, ex ante, it would be uncertain which party might efficiently breach if and only if negative damages were awarded, and so no categorical rule would function effectively. Put another way, the apparent one-sidedness of the negative-damages problem is merely an artifact of these illustrations, which, like all illustrations, attempt to isolate on particular issues. At least for some parties, the true nature of the negative-damages problem is bilateral and requires a bilateral solution.

V

EXPRESS TERMS

The analysis provided so far suggests that negative damages would sometimes benefit parties to a contract and sometimes burden them. In the former case, where the law's disallowance of negative damages imposes a net cost, the simplest response is an express agreement that authorizes such damages. Yet parties do not, in fact, include negative-damages clauses in their contracts, or at least such clauses are not common, either at the time of contract formation or thereafter.⁹¹ This fact leads to an inevitable question: Why? There

⁹¹ A commodities or securities contract may permit a seller to tender cash rather than the commodity or security to be traded, but these are wagers on market prices, not transac-

are at least four explanations, each consistent with the foregoing discussion: information asymmetry may plague negotiation for a negative-damages clause; such clauses might not be enforceable under current legal doctrine; business norms may discourage the adoption of negative damages; and extant law or different express terms may provide superior alternatives. This Part explores these explanations in turn.

A. Information Asymmetry

Just as information asymmetry can burden negotiation for efficient termination at the time of the performance-or-termination decision, a point discussed in Part III.A, such asymmetry can similarly burden an attempt to negotiate for a negative-damages clause in advance of that decision. For example, to avoid the searchunderinvestment problem identified in Part III.A, the parties might negotiate at the time of contract for a promisor's right to collect negative damages upon termination. This could induce the contractor to search optimally and increase the expected value of the contract. But in their negotiations over contract price, the parties would seek to incorporate the prospect of negative damages rather than cede the entire benefit to the contractor, and such negotiation could be difficult. The contractor may have a clear idea of how much search is optimal and how likely termination will be at the close of such search. Perhaps efficient termination is relatively likely so that the contractor should be willing to accept a relatively large price reduction (compared to a contract with no negative-damages clause) for the option both to pursue an alternative project and to collect negative damages. But the contractor may insist that only a small reduction is in order, and the landowner may not know what to believe.

A key observation here is that the contractor would attempt to prove that it has *no* alternative project and little prospect of finding one. In doing so, the contractor might convince the landowner that the contractor is likely to perform and thus unlikely to profit from negative damages even where the landowner would lose on the contract; a modest price reduction for the negative-damages option would thus be reasonable. Even if the contractor is truthful, however, it is difficult to demonstrate a null set. A bargain might not be possible at all under these conditions.

tions in which performance may have become inefficient. *See, e.g.*, Rosemarie Oda, *Retail Foreign Exchange: A New Opportunity for Banks*, BANKING & FIN. SERVICES POL'Y REP., Jan. 2008, at 1, 5 (describing cash settlement of commodity futures contract).

B. Legal Impediment

Despite the foregoing, one might speculate that at the time of contract formation, as opposed to the time of the performance-ortermination decision, the value of a negative-damages option may not be difficult for either party to estimate fairly, albeit imprecisely. That is, far in advance of the termination decision, information asymmetry may be relatively mild. And at the time of contract formation, without an impending performance decision, there would be time to resolve any asymmetry that may exist. So there may be another explanation for the absence of negative-damages provisions.

Parties may predict that a negative-damages clause would be unenforceable as unconscionable (and that the disallowance of such damages is thus a mandatory, rather than a default, rule). Liquidated damages are unenforceable if they are set in excess of expected or actual loss,⁹² and negative damages, paid as they would be to the party in breach who suffered no loss from such breach are quintessentially excessive by this standard. Parties to a contract may well be reluctant to write and rely on a term the enforcement of which is doubtful.

C. Business Norms

Another possibility is that parties do not wish to deviate from the norm and identify themselves as ones who contemplate a failure to perform. Recall from Part I the Humean notion that one is morally obligated to do what one promises. This moral sentiment may be translated into business ethics and practice. No business person wants conflict to be the result of her contract, particularly in a legal system that has each litigant bear its own expenses.⁹³ Like one who contemplates marriage, a business may shy away from a partner who wants to discuss breakup even before the union. This may be a reason why liquidated-damages clauses are not more common and why a clause that would permit a party both to terminate the relationship and collect damages would be a difficult innovation.

D. Superior Alternatives

More importantly, perhaps, the absence of negative-damages clauses may be explained by the very nature of the tradeoffs inherent

 $^{^{92}}$ See RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981) ("Damages for breach ... may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.").

⁹³ See generally, e.g., James W. Hughes & Edward A. Snyder, *Litigation and Settlement* Under the English and American Rules: Theory and Evidence, 38 J.L. & ECON. 225 (1995) (comparing rules on incidence of legal fees).

in negative damages themselves. That is, because parties cannot easily limit the allowance of negative damages to circumstances in which they would be beneficial, they may either accept the default rule of expectation damages, conditioned by the mitigation doctrine, or adopt an alternative express term. Acceptance of the default rule is discussed in the next Part of this Article (where the mitigation doctrine is richer and more nuanced than in the illustrations presented above). Consider first whether the common provision of liquidated damages or what is sometimes its functional equivalent, a specific-performance provision—might be seen in the light of the above analysis as an alternative to negative damages.

With liquidated damages in mind, return once again to the construction-contractor hypotheticals from Parts III and IV. The contractor and landowner might agree to a high-liquidated-damages clause, or a specific-performance clause (one that does not require the contractor to mitigate), applicable in the event that the landowner repudiates or otherwise breaches the contract. Either clause would give the potentially more efficient searcher-the contractor-some incentive unilaterally to locate mitigation opportunities, and neither clause would induce a race to repudiate, whatever the background information, as repudiation would be either costly or impossible for the landowner. (Were it desirable, as might be the case in a richer illustration, to prevent contractor repudiation as well, the high liquidated-damages or specific-performance clause could be bilateral.) Because the landowner will not repudiate even with information about the likely benefit of termination, the result might be postsearch negotiations with more complete information than would otherwise be possible. Fully informed negotiations are less likely to be costly and more likely to be successful than those with incomplete information, as differences in information leave room for significant differences of opinion.94 Here, the contractor could provide evidence of its prospective cost, including opportunity cost, and negotiate with the landowner for efficient termination.

A high-liquidated-damages clause or a specific-performance clause would not always yield efficient outcomes. Where termination is efficient, but where unilateral repudiation is not in the interest of either party, negotiation forces the parties to share the benefits of termination. This is less than ideal if the efficacy of termination can be discovered only through search. As noted above, in anticipation of sharing, even an efficient, unique searcher will underinvest in search,

⁹⁴ See supra note 57 and accompanying text (stating that negotiations can be costly or can break down when there is information asymmetry).

and a negotiated cure to such inefficiency might prove impossible. Thus, the problem of Part III.A would not be solved entirely. Moreover, neither a high-liquidated-damages clause nor a specificperformance clause would beneficially address the contractor's bias toward continuation, borne from variance in judicial estimation, as illustrated in Part III.B. Similarly, neither clause would reduce the incentive for strategic use of the material-breach doctrine, the phenomenon illustrated in Part III.C. Thus, it is not surprising that draconian damages or performance clauses are not ubiquitous, even as substitutes for negative damages.

Still, it may be that a contract with a high-liquidated-damages clause, or with a specific-performance clause, reflects the parties' attempt to balance competing concerns raised by the disallowance of negative damages as a default rule. This default, then, as part of the expectation remedy, provides an argument supplemental to those extant for judicial enforcement of so-called "penalty" clauses and of specific-performance clauses.⁹⁵

VI

The Mitigation Doctrine

On its face, the mitigation doctrine has little to do with the disallowance of negative damages or with the ambiguous efficiency consequences that the allowance of such damages would yield. On closer analysis, though, there is an important connection. Specifically, a weak form of the mitigation doctrine as it is applied in practice—as opposed to the strong form assumed in the above illustrations—curbs some of the perverse incentives created by the disallowance of negative damages. In combination, therefore, a weak mitigation doctrine and the disallowance of negative damages may be generally efficient, perhaps even more so than the allowance of negative damages, which would carry the bitter along with the sweet.

To understand the role of the mitigation doctrine in the analysis of negative damages, begin with a closer look at the doctrine itself. In principle, the expectation remedy awards the victim of breach its loss from the failure of performance less any part of the loss the victim could have avoided. Consider once more the construction-contractor hypotheticals from Parts III and IV. When the contractor repudiated and the landowner valued the building by more than the price of sub-

⁹⁵ See, e.g., Lars A. Stole, *The Economics of Liquidated Damage Clauses in Contractual Environments with Private Information*, 8 J.L. ECON. & ORG. 582 (1992) (arguing that even high-liquidated-damages clauses can promote efficiency by harnessing parties' information, among other benefits).

stitute performance, the landowner's expectation damages were measured by the difference between the market price for performance and the contract price (plus any other injury caused by the breach), *not* by the potentially greater difference between the value to the landowner of the building and the contract price.⁹⁶ If the landowner failed to hire substitute performance, the consequential loss would be borne by the landowner, not the contractor. Doctrinally, a court would say that the landowner had failed to mitigate its injury from the contractor's breach.

This account of the mitigation doctrine, however, is too broad and insufficiently detailed. In practical application, the victim's duty to mitigate is limited. The victim need not accept any and every alternative project in mitigation. In some cases, it seems that the victim need not accept substitute performance unless that performance is fungible with that promised under the contract.⁹⁷ In a now famous example, the actress Shirley MacLaine (Parker) was under contract with Twentieth Century-Fox to perform in the movie *Bloomer Girl.*⁹⁸ Fox cancelled the movie and requested that she act in a substitute movie, *Big Country, Big Man*. MacLaine declined yet won damages from Fox for its repudiation of the *Bloomer Girl* contract, damages unreduced by MacLaine's refusal to mitigate with earnings from *Big Country.*⁹⁹ As stated by the California Supreme Court, the duty to mitigate does not extend to a project that is "inferior" in quality to the contractual project.¹⁰⁰ At least in some jurisdictions, then, although a

⁹⁶ There is, of course, the possibility that the value of performance to the promisee will be less than the cost of substitute performance. But this possibility is inapposite to the discussion here. *Cf. supra* note 39 (explaining that cost of cover is relatively uncontroversial basis for damages).

⁹⁷ See RESTATEMENT (SECOND) OF CONTRACTS § 350 (1981) (reporting that law excludes recovery for loss only if avoidable "without undue risk, burden or humiliation"). The comments, illustrations, and cases associated with this section of the Restatement suggest that the mitigation obligation does not require a party to take on work of a different nature. For example, although comment e states that "discrepancies between the transactions" do not alone form a basis for a party to refuse mitigation, illustration 11 to that comment provides that work as a farm laborer is not regarded as a substitute for work as a farm supervisor. This principle is not limited to employment cases. *See, e.g.*, Landry's Seafood House-Addison, Inc. v. Snadon, 233 S.W.3d 430 (Tex. App. 2007) (finding that after tenant's repudiation of lease, mitigation obligation does not require landlord to accept substitute tenant unless that tenant is "suitable under the circumstances"). For a related analysis under the Uniform Commercial Code, see Edlin, *supra* note 24, at 111–12.

⁹⁸ Parker v. Twentieth Century-Fox Film Corp., 474 P.2d 689, 690 (Cal. 1970).

⁹⁹ Id. at 693.

¹⁰⁰ *Id.* A close study of the facts reveals an argument that Fox had expressly agreed to pay MacLaine in full for the option of her availability. *See* VICTOR GOLDBERG, FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE 279–309 (2006) (describing MacLaine's option as "pay-or-play" provision). Such an express provision would shift analysis from the mitigation doctrine to the law of liquidated damages (the latter because the option

victim of breach must mitigate with a project at an inferior price, she may avoid mitigation if the project is of inferior quality.

Ostensibly, this limitation is inconsistent with efficient breach theory. It might seem that a better rule would require the victim to mitigate with any alternative project if the project would reduce damages (and thus societal loss) to any extent, even if the alternative project is somewhat unsatisfactory to the victim of breach and, consequently, would reduce damages by less than the price the victim receives for the project. Edlin, for example, has argued for this result, which would avoid overcompensation and the consequent distortions to investment incentives (a concern even if the parties negotiate for efficient mitigation).¹⁰¹ Thus, the actual mitigation obligation may seem wastefully weak as compared to the ideal.

The analysis of this Article, however, suggests that the current limitation on the mitigation obligation might be the better rule after all, at least as a default. Consider one last time the illustrations from Part III.A, in which a promisor possessed private information or a unique search opportunity. In these illustrations, under a sufficiently limited mitigation obligation, a contractor with an alternative project could freely approach the landowner and engage in an informed negotiation over the terms of termination. If the mitigation obligation were unlimited, the contractor could not inform the landowner of a mitigation opportunity without fear that the landowner would simply repudiate and capture the entire surplus from termination. In anticipation of this outcome or of a negotiation plagued by information asymmetry, the contractor might forgo an efficient termination or have little incentive to search for a mitigation opportunity. Thus, the limitation on the mitigation obligation enhances the contractor's ability to exploit a known mitigation opportunity and provides the contractor with an incentive to search for such an opportunity, albeit one weakened by the prospect that it will have to share the benefits of termination.

In this context, the limited mitigation obligation may be seen as a compromise between the allowance of negative damages, which would provide a robust incentive for efficient repudiation, among other benefits, and their disallowance, which avoids the costs of the repudiation race described above in Part IV, among other costs. The result is sim-

price might be characterized as liquidated compensation for the studio's failure to employ MacLaine in the movie). But the court did not find an express option, and thus the precedent is as described in the text.

 $^{^{101}}$ Edlin, *supra* note 24, at 111–12; *cf.* MacIntosh & Frydenlund, *supra* note 30, at 114 (recommending mitigation obligation defined by reference to "capital budgeting" methods).

ilar to that of a liquidated-damages clause or a specific-performance clause, described above in Part V, in that, like these clauses, the limited mitigation obligation effectively prevents unilateral promisee repudiation. There is a cost, of course, in that a weak mitigation doctrine will in some settings yield an insufficient incentive to mitigate. But this tradeoff may be sensible.

CONCLUSION

The analysis offered here identifies a gap in contracts theory scholarship on the topic of negative damages, a topic that might also be referred to as expectation damages in the case of victimless breach. The disallowance of negative damages likely imposes costs in some situations, for example, where a promisor has private information that breach is efficient but profits from the contract. Disallowance also likely generates some benefits in other situations, for example, where a costly repudiation race would otherwise ensue. Where parties do not adequately consider the remedy for breach at the time of contract formation, it is possible that efficiency would be served with a default rule that allowed negative damages, at least in circumstances in which the court determines (difficult though this may be) that the party in breach would not have breached but for the allowance of negative damages. This default might be appropriate if one assumes that negotiation over a negative-damages clause would be expensive or impossible after formation. These and other questions require further theoretical and empirical analysis; this Article is but a step toward a general theory.

Even under current law, where the default rule disallows negative damages, the analysis presented here offers guidance. The arguments contained in this Article should give courts pause, or additional pause, before they insist on an expectation remedy and disregard a contract clause for liquidated damages, even if high, or for specific performance. These arguments also offer some support for the common law limitation on the obligation to mitigate, which may be weak, but usefully so.

Appendix

Consider a contractual relationship with the following characteristics:

- *P* is the contract price;
- *C* is the promisor's cost of completion;
- *B* is the value of performance;
- *D* is the damages remedy.

It follows that:

- Termination is efficient if and only if C > B;
- Promisor will repudiate if and only if C P > D;
- Were D = B P, the promisor would repudiate if and only if breach were efficient.
- Ex post efficiency would be served, then, if *B* and *P* are observable to both parties and verifiable to a court even if *C* is known only to the promisor.

Further:

- Repudiation is efficient if and only if C > B;
- Promisor will repudiate if and only if C P > D;
- Because D = max[0, B P], where B P is negative, it is possible that:
 - C P < D; and
 - C > B.
- That is, the promisor may have an incentive to perform inefficiently.

Thus:

• Where C is known to the promisor but not observable to the promisee and where B is both mutually observable and verifiable to a court, a rule that permitted negative damages, i.e., one that set D = B - P without restriction, would yield efficient breach through repudiation while the expectation remedy of D = max[0, B - P] sometimes will not.