Taboo Breach: Convention & Efficiency in Contract Performance

Richard R. W. Brooks[*]

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1 Introduction

"Better break your word," advised the English theologian Thomas Fuller, "than do worse in keeping it." Fuller's advice would seem all the more persuasive when breaking the promise makes no one worse off, while keeping it would cause detriment to some or all involved. What is the point of performing such a promise when it can be avoided? If there is a point, it must reside in some abstract ideal because commonsense surely favors avoidance of obligations that serve no purpose other than fulfilling themselves. Often, of course, these obligations are not merely naked promises, they are also contracts—that is to say, legally enforceable promises—with duties imposed by law, quite apart from what commonsense would dictate. Yet contracts, too, are subject to practical reasoning.

When someone makes a contract promise two things, potentially, are accomplished. A promise is made and, if it is properly accepted, a contract is formed. Should the promisor then, without the promisee's consent, abandon the contract promise in order to pursue an *objectively* superior course, the promisor would break both the promise and the contract. My immediate concern is the latter: the breaching of contracts better broken than kept. Conceding the value in avoiding performance of these contracts, what practical and normative stance should law adopt with respect to their breaches?

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[*]*richard.brooks@yale.edu.*

To insist always on performance of the promise, notwithstanding the value of its avoidance, would betray ordinary sensibility and is nowhere the law. To deny the obligation to perform, on a mere showing of an objectively superior alternative, would be an absurd distortion of the legal rule. Law rejects both routes.

Some say, however, that law does, and should, give a nod toward breach when expectation damages are known to follow.[1] The fact that breach, followed by expectation damages, theoretically precludes futile performances certainly recommends it. But, this recommendation gives breach and the damage measure no normative priority, either in terms of economic efficiency or morality, over an infinite set of remedial alternatives that also preclude futility. The efficiency claim, which applies to allocation, investment and search, among other economic considerations, is presented in the appendix. Consider now the morality claim.

Ordinary morality offers no clear directive when it comes to promoting social welfare through individual actions, including breaching efficiently. This is an important point, too often obscured in the debate. Promisors are neither morally prohibited from breaching in cases where the cost of performance outweighs its value, nor are they morally required to breach when doing so would increase social welfare. The latter assertion, unlike the former, goes unquestioned in the normative debate, though it is not evidently beyond questioning. Why shouldn't a promisor be morally required to breach if doing so can lead to greater social welfare without harm to the promisee or promisor? Why not, a moral duty to breach, efficiently?

Whatever the merits of such a duty, no one seriously maintains that law or morality ought impose obligations on subjects to take actions that lead to greater social welfare, especially where those actions entail breaching a prior duty, such as a contract promise.[2] While law is not unyielding—a

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[1]See e.g., Judge Posner's opinion in Patton v. Mid-Contintent Systems, Inc., 841 F.2d 742,750 (1988), observing that law doesn't want to deter breach of contract promises more costly to perform than they are valued. "Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee's actual losses. If he is forced to pay more than that, an efficient breach may be deterred, and the law doesn't want to bring about such a result. Id. [add other cites].

[2]*Cf.,* Shelly Kagan, The Limits of Morality (Oxford: Clarendon Press, 1989, at 204), presenting a compelling case to expand the scope where "[a]n agent is morally required to perform ... that act which can be reasonably expected to lead to the best consequences

contract promise does not bind a promisor to a course of conduct abso-
lutely,[3]—courts have never recognized welfare as a sufficient condition for
the release or imposition of contract performance duties. Promisors have no
general *duty* to breach, efficiently, for the same reason they have no *right* to
efficient breach. Consent, the masterframe for contracts, is absent in both
instances.[4]

Consent, and not welfare, is the controlling warrant for the imposition
of contractual rights and duties. Even those most committed to the wel-
fare claim in the efficient breach hypothesis, look to justify nonperformance
through consent (implied or constructed); a welfare or efficiency analysis
can suggest when it is reasonable to infer consent, which can justify breach
or perhaps make it permissible; efficiency itself, however, cannot authorize
breach, it is simply an interpretive tool, used to reveal the hidden consent,
determining the degree to which contractual promises oblige.[5]

Because "a contract looks to its fulfillment and rarely anticipates its
breach," consent to breach is seldom expressed in agreements.[6] When ex-
press consent is missing from an agreement, looking for it through the lens
of welfare will only get you so far because the relationship between welfare
and plausible implied consent is more of a correspondence than a one-to-
one mapping. The principal aim of this essay is to elaborate this claim and
demonstrate the limitations of looking for consent in welfare. First, however,

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overall." But even Kagan would not go so far as to, *generally*, require breach of contract
to promote welfare. [pin cite] *See also*, Shelly Kagan, "Defending Options, 104 Ethics 333
(1994); Michael E. Bratman, "Kagan on 'The Appeal to Cost,' " 104 Ethics 325 (1994);
Jeremy Waldron, "Kagan on Requirements: Mill on Sanctions," 104 Ethics 310 (1994).

[3] "It does not bind absolutely, because, while a promise binds one against reconsidering
ones intention simply on grounds of ones own convenience, it does not bind one to do the
thing promised whatever the costs to oneself and others." T.M. Scanlon, What We Owe
to Each Other, The Belknap Press of Harvard Univ. Press, 1989, at 309. Contract law's
excuse doctrines most obviously reflect this intuition, but it is found elsewhere as well.

[4] Certain tort-like duties to rescue or to promote welfare in extreme cases may be
implied by a social contract, but for private contracts there are no such duties absent
consent. [expand]

[5] Rights and duties to perform or not perform certain acts may come about without
consent (as observed in quasi-contract and torts, for instance) and they may even spring
from welfare considerations (for example, when the state properly exercises its takings
power), but in such cases the basis of law is always something other than *contract*.

[6] McJunkin Corp. v. Mechanicals, Inc., 888 F.2d at 481 (6th Cir., 1989, J. Engel).
Consent to breach may be inferred from some liquidated damage clauses, suggesting the
promisor may breach and pay a stipulated sum, but often even where there is a liquidated
clause the parties are not giving each other permission to breach so much as assuring a
remedy that avoids undercompensation.

Section 2 explores the implausible "duty to breach" as a means of getting at the taboo aspects of efficient breach. That is, once the conventional critiques against efficient breach are addressed, what's left (I believe) is essentially a taboo against breaking promises to increase wealth. Addressing such concerns related to the sociology of contracts and their breach is the direction the debate ought take. Turning to economic theory for insight will generate little that's new or interesting.

Section 3 then deals with the indirect moral argument for efficient breach. The direct moral argument for efficient breach, if one is to be made, must be a utilitarian one of some kind. Yet law and economics proponents of efficient breach have tended to steered clear of utilitarian arguments for the moral basis of the claim.[7] They have instead looked for morality in an imagined consent.[8] Professor Steven Shavell has made the most recent argument justifying efficient breach in terms of a hypothetical consent.[9] The upshot of this section is simply that the hypothetical consent framework does does not translate well to actual consent.

Yet, as shown in the model in the appendix, one could allow for actual consent (while staying within the confines of the rationality framework that the efficient breach argument presupposes) without sacrificing efficiency. Consent, however, is not the sole objection to efficient breach. Observers also resist the idea of the breacher gaining—enriching himself—from breaching. But this objection can be addressed too in the structure of the model. With these conventional critiques addressed, the essential opposition to efficient breach can then be looked at squarely. Taboo norms ultimately constrain efficient breach—as if to say, "breaching because it is efficient is something that is simply not done among us," as a matter of propriety.[10]

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[7]The strongest advocate for the economic analysis of law would not appeal to utilitarianism. "Natural as the alliance would appear, Posner would have none of it," observed Coleman, "and for the simple reason that he had been convinced by the classic objections to utilitarianism. Maximizing utility can often lead to injustice, sacrificing the one for the good of the many. Utilitarianism is a defective moral theory, an inappropriate standard on which to justify state coercionor so Posner himself thought." Jules L. Coleman, "The Grounds of Welfare," 112 Yale L. J. 1511, 1516.

[8]"To find a moral foundation suitable to efficiency, Posner looked to a particular conception of Kantian moral theoryone that emphasized the importance of individual autonomy as expressed in the capacity to consent.

[9]See also, Daniel Markovits and Alan Schwartz, "The Myth of Efficient Breach: New Defenses of the Expectation Interest," 97 Va. L. Rev. 1939 (2011).

[10]Judge Engel made the point well: "Hard bargaining, [and] 'efficient' breaches ... are all acceptable, even desirable, in our economic system. That system can be viewed as a game in which everybody wins, to one degree or another, so long as everyone plays by

The essay concludes by proposing an alternative criterion—labelled the "participation interest"—by which we might evaluate the permissibility of breaching efficiently. A participation interest is a broad and general feature of every voluntary exchange, running though the entire course of the transaction from formation to completion or abandonment. That is not to say each party must participate at every moment or in every decision; rather, it implies only that a party's participation should be reflected in decisions that matter to her over the course of the contractual relationship—even if that reflection merely indicates that she delegated to the other party authority over these decisions.[11]

2   The Duty to Breach

When the promisor "does not gain," but merely limits a loss by not performing a *losing contract*, even the staunchest critics of efficient breach might find that sort of efficient nonperformance unobjectionable.[12] One might imagine that the promisor and promisee in such a case would come to a mutual agreement to release the promisor for performing, so nonperformance would not constitute breach. If this is the case, then the efficient outcome will result through consensual bargaining (Coase, 1960). But assume the parties cannot engage in Coasean bargaining, which sometimes happens of course. Moreover, assume the seller realizes that the contract is a losing one for the buyer, who does not yet realize this fact,[13] and the seller cannot credibly communicate the information to the buyer before performance is called for. In this case, would it be morally permissible for the seller to breach the contract for the benefit of the buyer? Let's say that the seller will receive the contract price in any event, and reputational or other concerns do not

the common rules. Those rules are not limited to precepts of rationality and self-interest. They include equitable notions of fairness and propriety ..." Rich and Whillock, Inc. v. Ashton Development, Inc., 157 Cal.App.3d 1154, 1159 (Ct.App.1984).

[11]Adding a little more clarity to this loose definition, let me identify two meanings I definitely do not intend. First, the participation interest is not a right to control the course of performance or a right to control the promisor. Second, the participation interest is not a right to share in the gains from efficient breach, although such sharing may be good evidence that the participation interest is satisfied.

[12]See Daniel Friedmann's polemic retort to efficient breach, where he equates it with efficient theft. D. Friedmann, "The Efficient Breach Fallacy," (1989) 18 Journal of Legal Studies, 1-24.

[13]Seller's often have relatively greater insight about the expected value of performance—especially in the case of one-time purchases or emotionally-ladened acquisitions where buyer's regret often follows—because of experience dealing with many buyers over time.

weigh on her to perform, might we say that the seller has a moral obligation to breach the contract for the benefit of the buyer?

One might object by saying that the seller may be mistaken about the facts or otherwise ought not make the decision, paternalistically, for the buyer. So assume that the buyer, following a breach by the seller, may compel specific performance. Hence the only effect of the seller's breach is to avoid a wasteful performance if the buyer in fact is better off without it, but the buyer can after the fact decide to compel the performance. In this case, it seems senseless for the seller not to breach for the benefit of the buyer.

Alternatively, one might object by saying that the seller gets nothing from the breach and therefore would not breach. But that's not entirely satisfactory. First, we must acknowledge that the seller is indifferent to breach here: she gets exactly the contract price in either case. Moreover, why not impose a moral duty to rescue the buyer here. Individuals who cringe at the bad Samaritan who walks by a drowning man when he could easily through a rope to the man in trouble should feel some unease in this case too. Yes perhaps the man was attempting suicide, making the Good Samaritan's paternalistic intervention officious. In the case of the Samaritan there is at least some cost, however trivial, to rescuing the other party, but in the case of the promisee with the losing contract, there is, by assumption, no cost to the rescue. The promisor is left perfectly indifferent between breach and performance. So why not say that she, the promisor, has a moral duty to help the other party by not performing.

If you find any traction in the argument for losing contracts, then allow me to go a little further. Let's say that the promisee is perfectly indifferent between the promisor's performance and breach even before damages—that is, his value of the promisor's performance is exactly zero—but the promisor may generate a surplus by redirecting her efforts to another party. Here, of course, the standard objections to the conventional efficient breach argument apply: there is something undesirable about the promisor gaining a surplus from breaching and it is the promisee's privilege to release the promisor for her obligation to perform, rather than a self-executing right of the promisor. So let's disgorge the promisor of arbitrarily all the gain (and give the gain to the promisee or to charity) and let's have the promisee decide whether to compel the promisor performance after the fact. In this case, again, might we say that the efficient breach is morally permissible, if not morally required? I advance no argument here about the promisee's decision to

compel performance at a cost to society. That is a separate question. My focus here is the promisor's breach.

Allowing further that the promisee's contract is not a losing one, nor is he strictly indifferent between performance and breach before compensation, but rather could be made indifferent or better-off with breach followed by compensation. In this context, the typical setting from which the conventional efficient breach hypothesis departs, can there be a case for morally permissive efficient breach? Again, matters of surplus division and legal rights to performance are significantly variable in this context too. Once concerns about the promisor's gaining "too much" of the surplus from breach and the promisee being denied his right to elect performance are addressed, the usual grounds for objecting to efficient breach are substantially weakened. What's left, then, is the essence of the taboo against efficient breach.

2.1 The Taboo Against Breach

What can explain the source of a persistent taboo against breach even in a world where the value of breach is recognized and breachees are left no worse off following any particular breach? I will below suggest one possibility, not one to which I am necessarily committed nor the only possibility I can imagine,[14] but a possibility to suggest the direction that the debate might take, instead of maintaining its current limited scope. First, however, it is necessary to account promises and promise-keeping in this world. That is, it is easy to justify *performance* and *breach* when welfare dominates as the criterion for action. The challenge, in this world, is in justifying *promises* and *contracts* as a distinct categories giving reasons for action in the first place.[15] Why bother promising or contracting today, if tomorrow you will only be obligated to do only what's efficient any way, and not, necessarily, what you promised or contracted to do.

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[14] In the next draft, and hopefully at the talk, I will discuss another possibility based on *types* and signaling, in the nature of Andrei Shleifer & Lawrence H. Summers's, "Breach of Trust in Hostile Takeovers," in Corporate Takeovers: Causes and Consequences (Alan J. Auerbach, ed., 1988)

[15] "The theory is said to be too permissive, because it permits agents to break intuitively appealing moral rules [like promises] whenever more good (on balance) will come from breaking them than from keeping them. In fact, it doesn't merely permit agents to break rules in such circumstances, but it demands that they do so." Alastair Norcross, "Act-Utilitarianism and Promissory Obligation," in Promises and Agreements, 217, 230 (Hanoch Sheinman ed., 2011)

In this setting, as Alastair Norcross observes, "it might appear that utilitarians can't even consistently make promises," that "the institution of promising couldn't exist in an act-utilitarian society." To address this concern, Norcross introduces a sophisticated consequentialist, who maintains a "standing commitment" to welfare while holding on to other values—like keeping promises for their own sake or some other nonconsequential value. With this new more broad-minded actor, there may now be reasons for making and keeping promises, which would not undermine the utilitarian directive of the sophisticated consequentialist so long as she lets go of those other values when sticking to them would be inefficient.

Moreover, a sophisticated consequentialist theory can justifies promises in terms of the idea that promising's general promotion of welfare makes it a justifiable moral commitment. At the same time, this justification contains within it the argument for efficient breach: if breach will in fact bring about more good in the world, then in such cases promising does not deserve special status at all. But it is not clear how Norcross would resolve the tension between a general commitment to welfare and other moral beliefs—a tension he views as "a fact of the moral life, not a problem for an account of morality."[16] If welfare always wins, then other moral beliefs have no bite for the sophisticated consequentialist. If welfare can lose, how can a committed consequentialist justify the loss?

Moving from evaluating welfare based on individual acts to a consequentialism based on rules, Brad Hooker offers a helpful formulation, where one first selects rules by their consequence and then evaluates acts based on the selected rules.[17] In his own words,

> An act is wrong if it is forbidden by the code of rules whose internalization by the overwhelming majority of everyone everywhere in each new generation has maximum expected value in terms of well-being with some priority for the worst off. The calculation of a codes expected value includes all costs of getting the code

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[16]Norcros at , at 236. For what it is worth, when one thinks about tensions in moral life, the most obvious one is between our moral beliefs and our desires, which are fundamentally different from commitments.

[17]Rule-consequentialism should be formulated in terms of rules whose consequences have the greatest expected value." Brad Hooker, Promises and Rule-Consequentialism, in Promises and Agreements, 237, 244 (Hanoch Sheinman ed., 2011). And rule-consequentialism is "best formulated," according to Hooker, "in terms of assessing rules in terms of agent-neutral impartial value." *Id.* at 245.

internalized.[18]

Two aspects of this view merit emphasis. The first is the idea that internalizing a general practice may be second-best efficient and the best we can do. The second is the cost of code switching.[19] On the former, because we are boundedly rational—i.e., intendedly rational but unable to act with perfect rationality across all eventualities—we develop heuristics and rules of thumb to guide our conduct.[20] "But for bounded rationality," argues Oliver Williamson, "all economic exchange could be efficiently organized by contract, by which he means *fully-specified contracts.* That is, contracts do more than just simply stipulate some action or forbearance, X, (*simple contracts*), but rather contracts that specifies a considered action or forbearance for every possible contingency the parties might encounter.[21]

In a world where bounded rationality prohibits first-best contracting, a simple rule of performing simple contracts, supported by a taboo against breaching, may be second-best. Note that there needn't be anything morally distinctive about promises, *per se*, as David Hume famously observed in denying that promises had any natural morality to them. Promises, according to Hume, are mere coordination devices,[22] perhaps signaling a stronger commitment to some course of action, than, say a mere prediction or weak intention, but in the end promises are just another convention facilitating coordination. But why not abandon the promise when it is clearly not efficient in some cases? To address this question, let's turn to the second aspect of Hooker's account, concerning the costs of getting a the code internalized.

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[18] *Id.* at 244.

[19] It is also noteworthy that the view does not tie morality directly to maximization of utility. Instead, it ties morality to the internalization of a code of rules that maximize expected value.

[20] Simon, Herbert (1957). "A Behavioral Model of Rational Choice, in Models of Man, Social and Rational: Mathematical Essays on Rational Human Behavior in a Social Setting, 1957.

[21] Oliver E. Williamson, The economics of organization: the transaction cost approach, 87(3) American Journal of Sociology 548 (1981) at 553. However, even if parties were unboundedly rational, *indescribability* and the *ink cost* of full specification would still put limits on the contracting solution suggested. See Eric Maskin & Jean Tirole, Unforeseen Contingencies and Incomplete Contracts, 66(1) Review of Economic Studies, 83, 1999 (on indescribability) and Ronald H. Coase, The Nature of the Firm, 4 Economica 386 (1937). (on ink costs).

[22] David Hume, A Treatise of Human Nature, 516-523 (1839). Not everyone agrees, of course, with this formulation. For instance, some philosophers reject the social coordination hypothesis as being poor grounds for understanding promising. See, e.g. David Owens, The Problem with Promising, in Promises and Agreements, 58, 71 (Hanoch Sheinman ed., 2011).

Take, as a point of departure, the existence of a rule, which "if internalized by the overwhelming majority of everyone everywhere in each new generation" maximizes welfare. Because it is costly for people to manage varied and complex rules, in large part due to our bounded rationality, once a rule to becomes internalized, the costs of switching to different (even more efficient) rules can be prohibitive. We can see this in Hooker's account. As individuals increasingly agree over time on the agent-neutral rules that promote the greatest expected value, they seem to incorporate those rules into their codes, like the rules of thumb. Rather than attempting to code-switch here and there on a one-off basis, or allowing a contracting partner to breach (absent consent or participation) when efficiency calls for it in the immediate instance, a greater expected payoff may realized by complying with the general rule and holding non-compliers to scorn for violating the taboo.[23]

In the paragraphs immediately prior, I attempted to use bounded rationality and an incomplete contracts framework to outlined an argument that a committed utilitarian might make against efficient breach. Whether this argument was convincing or not, I confess to an ulterior motive for making the argument as I did. I made use of the incomplete contracts framework because Steven Shavell has recently used it to argue for the morality of the efficient breach hypothesis. I now turn to this argument to demonstrate the hopelessness of hypothetical consent as a moral basis to justify breach.

3 Arbitrariness Critique of Hypothetical Consent

Professor Shavell employs an incomplete contracts framework to argue for the moral permissibility of efficient breach.[24] He develops the argument in

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[23]Hookers account speaks of rules selected because they result in maximized expected value relative to internalization costs when almost everyone everywhere complies. But, one can imagine different (or more complex) rules in different domains, such as in the impersonal and sophisticated contexts in which many "arms-length" transactions are conducted. The costs and benefits of internalizing different rules may facilitate a switch a code. *Cf.* Alan P. Fiske & Philip Tetlock, "Taboo Tradeoffs: Reactions to Transactions that Transgress Spheres of Exchange," 17 Political Psychology, 255294 (1997). Even as sophisticated actors more across different domains, however, there remains a risk of spillover and negative externalities for code switching. *See* See Seana Valentine Shiffrin, The Divergence of Contract and Promise, 120 Harv.. L. Rev. 708 (2007).

[24]See Steven Shavell, "Is Breach of Contract Immoral?," 56 Emory L. J. 439 (2006). See also, Louis Kaplow & Steven Shavell, Fairness versus Welfare, Harvard University Press, 2002; Kaplow, Louis & Steven Shavell, "Fairness versus Welfare," 114 Harv. L. Rev. 961

4 or 5 steps (depending on how you count them). First, he observes that if the contract expressly requires the promisor to keep the promise should an objectively better opportunity arise then breaching the contract is immoral. Second, if the contract expressly allows the promisor to pursue better opportunities when they arise, then there is no breach of contract, of course, let alone an immoral one. Hence, hard questions about whether a breach of contract is immoral largely turn on scenarios involving contracts for which the parties have not expressly provided terms that anticipate the circumstances surrounding the breach. To resolve these hard questions about the morality of breach, Professor Shavell next undertakes a simple inquiry: he asks what would the parties have stipulated in the contract had this contingency been anticipated and addressed.

Obviously, the paries would not have agreed to a term requiring the promisor to perform at all costs. Indeed, they would never require, in a fully stipulated contract, that the promisor perform when the cost of performance is greater than its value. Therefore, he concludes, breach leading to nonperformance in these cases is consistent with the agreement concerning performance that the parties would have reached had they addressed the contingency in their contract. With this, he establishes a criterion whereby breach is morally permissible: when the parties would have wanted nonperformance of the promise. In the final step, Professor Shavell observes that when the remedy is expectation damages, breach by the promisor allows us to infer that the parties would have stipulated non-performance in the realized contingency.[25] Why can this inference be drawn? "Because that is exactly when a seller would not have to perform in a completely detailed contract, the seller will fail to perform in the same contingencies as the seller would be permitted not to perform in a hypothetical complete contract. Accordingly, *breach should not be characterized as immoral when expectation damages are paid for breach.*"[26]

(2001).

[25]If the remedy is *fixed* at expectation damages, then it might appear that the only thing left for the parties to agree upon is whether there should be performance. However, the parties might stipulate other features in a more fully specified arrangement. For instance, a more fully specified term might give the promisor a right, power, privilege immunity associated with efficient nonperformance, with each of these entitlements tied to the payment of expectation damages. Or the term might deny the promisor a right to nonnerformance, treating it instead as a breach of a duty, requiring compensation of the promissee. Other possibilities exist as well.

[26]Steven Shavell, "Why Breach of Contract May Not be Immoral Given the Incompleteness of Contracts," 107 Mich. L. Rev. 1569, 1574 (emphasis in original). Professor Shavell says "that if damages equal the buyers expectation, breach can be inferred to be moral because it will occur only when the parties would have allowed nonperformance

The argument is true as far as it goes: rational parties specifying terms for contingencies, ex ante, would not call for performance when its cost is greater than its value; they would have agreed to release the promisor from the obligation to perform in those cases. The efficient allocation is the one the parties would have agreed to and, therefore, one might say this outcome carries a certain moral force despite being brought about through breach. The allocative outcome associated with breach is normatively justified in terms of this moral screen (i.e., it is what the parties would have chosen). But what about the distributive outcomes—the distribution of rents and the distribution of rights, who gets what and who gets to decide by law—associated with breach?

How can we know that the parties would have struck any particular bargain over rights and rents, like allowing the promisor to elect between performing and paying expectation damages? Is it not plausible that a rational promisee would have wanted the promisor to come to her first to get her release or at least her participation in the allocation decision concerning the performance that she, promisee, was expecting? Notice also that the promisor captures all of the gain from nonperformance when the background remedy is expectation damages. The promisee is left indifferent between the state where the promisor elects to perform and the one where she elects to breach and pay expectation damages, so by definition she woul dbe just as happy to have performance as she would to have breach and the remedy.[27] Is this really what they would have bargained for had they anticipated the circumstances surrounding the would-be breach? Would the promisee really agree to hand over all the surplus to the promisor and be left indifferent. Perhaps, but perhaps not.[28]

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in a complete contract." [1574]. This means nonperformance is moral, according to the criterion set out by Professor Shavell. "However, when damages are less than expectation, we cannot make the inference and would have to inquire directly about the costs of performance relative to its value in order to make a judgment about its morality." [1574-75] Yet, when damages are greater than expectation, the inference may still be drawn so long as they are less than the costs of performance.

[27]Assuming expectancy isn't factor in the price term, as discussed in more detail in footnote 28.

[28]True, the American remedial norm is indifference, meaning courts are charged with requiring breachers to make breachees whole by putting them in an equivalent position or state as the non-breach position or state. [Cite Mel Eisenbergs Indifference article. Although, it is not entirely clear that the so-called remedial default is agreed upon by courts or commentators; Cf. Seigelman & Thel; Farnsworths Your Loss My Gain, &c.] That's the directive for courts; a directive which may, in fact, have evolved from some majoritarian impulse. But, why should we think that this particular directive would have guided the parties bargaining in the counterfactual world where they had they foreseen the

Yet, if we cannot say with confidence that the parties would have agreed to any particular assignment of rights and rents in the hypothetical state then the morality screen that Professor Shavell offers becomes a sieve. It lets through a large number of alternatives, all of which leading to same allocative outcome.[29] Thus we cannot say, as he does, that breach should

circumstances surrounding the breach? Why wouldn't the promisee demand more than indifference given that she would be providing a contract term that allows the promisor the right to break the contract without the promisees prior consent or knowledge whenever it is in the promisor's individual interest to do so? Of course, the promisor might compensate the promisee for this right by offering a lower price ex ante. In this way, the promisee participates in the gains from efficient breaches in expectation. When the parties anticipate contingencies where efficient breaches might occur, they could factor that into the price term of the original agreement. But recall, we began by assuming they neither anticipated the circumstances surrounding the breach nor did the terms of their agreement, including the price term, account for the circumstances. If the price term did account for such circumstances, it would not be a breach at all [the second category, sort of, that Professor Shavell described]; one would just need to properly interpret the meaning of the price term. [This is the argument structure of Markovits and Schwartz, 2011.] The problem here, however, is not one of interpretation of an existing term, but the attempt to construct a non-existing term based on what we imagine the parties would have chosen. How can we know this? See Conclusion, which describes a thought experiment suggesting indeterminacy from hypothetical bargaining.

[29]Let Δ be the social gain from nonperformance of inefficient contracts, that is, $\Delta = [c(\sigma, \omega) - v(\beta, \omega)]^+$. It is often suggested that offering the seller anything less would lead to inefficiencies, but that is not true. For example, the promisor's share of the gains from efficient nonperformance may be represented by $\frac{1}{N} \cdot \Delta$, where $N \in \{1, 2, 3, ...\}$. In this case, the promisor gets the entire gain when $N = 1$, which is equivalent to the expectation remedy, leading the promisor to breach efficiently. Yet a she also breaches efficiently when $N = 2$ even though she gets only half the gain, and when $N = 3$ where she gets a third of the gain, and so on. This sequence may fairly represent the default division of the surplus for breach of contracts within N-party partnerships and joint ventures. (*See e.g.,* Meinhard v. Salmon and other cases.) As N approaches infinity the promisor's share of the gain approaches zero and the remedy becomes arbitrarily indistinguishable from the conventional disgorgement remedy commonly issued for breach of the duty of loyalty by fiduciaries. Still, at the margin, the hyper-rational promisor assumed in the conventional models will breach efficiently. One might argue that her investment incentives, already inefficient under expectation damages will be further degraded under a disgorgement like remedy. However, not that the buyer's incentive to overinvest in weaken under this remedy.

Which N would parties select if they had imagined the ex ante the contingency that leads a situation where breach is efficient. Observe that when Professor Shavell states the expectation breach followed by expectation damages is the remedy that parties would have chosen, he is in effect saying that $N = 1$ is the unique choice of parties. He says this is so because it leads to nonperformance in exactly those where the parties would have selected nonperformance in a fully specified contract. Yet any N from 1 to infinity would produce this result. Would partners or joint venturers choose $N = 1$, would principals select that denominator for breaches committed by fiduciaries? Would two ordinary contracting partners, like the prototypical buyer and seller, choose $N = 1$ as opposed to $N = 2$ or something very near it division?

Without assuming more, such as, it was the sellers effort and investigation that lead to

not be characterized as immoral when expectation damages are paid for breach because it reflects what the parties would have chosen in the fully specified contract.[30] However, nor can we say, as Seana Shiffrin claims, that breach *should be* characterized as immoral even when expectation damages are paid for breach. Since Professor Shiffrins argument against Professor Shavell's claim sheds light on the participation interest mentioned in the introduction, I will use it to introduce the next section.

4   The Participation Interest: A Sketch

To tease out the normative problem with Professor Shavell's efficient breach argument Professor Shiffrin asks her readers to imagine themselves as home-owners contracting with a plumber, who neither shows up as agreed nor calls, but instead allows the homeowner to sit around waiting all day for a service visit that does not occur.[31] No doubt many people, probably most, would resent being treated in that fashion. "If the no-show plumber were to appear next time matter-of-factly presenting you with a check or a discount reflecting the value of your time that was wasted I suspect," she says, "that,

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the realization of the efficient breach opportunity, and if one were to disgorge from her ex post the gains of breach she would not have incentive ex ante to find these socially useful opportunities. It is not hard to imagine the parties agreeing that if the seller should invest her resources in finding value enhancing opportunities that leave the buyer no worse off, then she should be rewarded for her investments with some or all of the gains from the efficient breach. Investment efficiency would require that result, not to mention fairness. However, but what about cases where the seller make no marginal investment in identifying the better opportunity? Would efficiency or fairness recommend that she captures the gains from her efficient breach? It is hard to imagine that the parties, in a situation where the seller stands to profit from a breach that was not anticipated (and therefore not incorporated in the contract price) and into which she invested no resources, that the buyer would agree to give all of the gains to the seller. When a seller gains as such, with indifference to the initial agreement, the buyer may feel that the the seller is not behaving fairly. It is not the the buyer necessarily wants all or half of the gain, or even that she wants specific performance. Rather the buyer may feel that the seller has violated a basic dignity or fairness taboo in her treatment.

[30]Breach causing nonperformance captures only one aspect of what the parties would have agreed to and multiple other rules can also bring this about.

[31]Both Professors Shavell and Shiffrin rely on personal service contracts—for snow removal and plumbing services, respectively—to illustrate their claims concerning the (im)morality of efficient breach. Whether, and to what extent, the intuitions they offer change when goods are exchanged between agents in market-based transactions are questions worth asking, but not pursued here.

after emerging from shock, the resentment would not fully dissipate."[32]

In relating this persistence of resentment to the general resistance that appears to confront efficient breach, Professor Shiffrin suggests a common problem. "When the plumber opts not to show (without consulting with you to gain your permission or waiver) because another job is more urgent or unfinished or pays better, even if we indulge the fantasy that the plumber would compensate you for your time and irritation, she has still made a decision for you about how your time, attention, and labor must be devoted." To drive home the point, Professor Shiffrin presses, by breaching the plumber "has made you an involuntary employee of hers. She has usurped your ability to make independent, involuntary decisions about the use and form of your time, attention, and labor."

For Professor Shiffrin, a problem with efficient breach is that it involuntarily alters the activities one must perform. But this claims too much. It recognizes a simple fact of human interdependency, with or without breach of contract. If the plumber had diligently showed up a bit earlier and worked a lot later than expected, without charging more, those actions too might alter the activities, involuntarily, of the homeowner. The underlying problem is not one of usurpation of the homeowners time, attention and labor, but rather a disregard of the homeowners interest in participating in the decision by the plumber to allocate, for some other purpose, the time the plumber had agreed to spend working for the homeowner. The problem, I think, concerns the unilateral reallocation of the plumber's time, attention, and labor—not the homeowner's *per se.*

The agreement between the homeowner and the plumber grants the homeowner some claim, some say, over the plumber's activities during the stipulated period. I am not suggesting that the homeowner has a right to fully command the plumbers activities in this period (i.e., there is no claim here that the homeowner has a right to any specific performances). Nevertheless, if the plumber seeks to redirect her time, attention and labor away from the homeowners job, then I maintain that the homeowner has an interest, however small,[33] in participating in the decision. When the

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[32]Seana Shiffrin, "Could Breach of Contract Be Immoral?," 107 Mich. L. Rev. 1551, 1564.

[33]The homeowners resentment may manifest even if her participation interest is small, and sometimes precisely because it is small. Say that a simple notification (a call, email or text message) was all the homeowner sought in the decision by the plumber to not show-up—notification not so that the homeowner could plan her day differently, but just

plumber disregards this interest, then her efficient breach runs counter to the commonsense morality of options, within bounds, that allows individuals to pursue or ignore efficiency or social welfare.

When parties anticipate contingencies where breach is efficient and factor them into the written terms of their agreement or reflect them explicitly in the price term or, more controversially, if they get reflected in the price implicitly,[34] then we may conclude that the parties both participate in the determination of the efficient breach outcome, i.e., they agree together beforehand that the promisor needn't perform the promise in these contingencies. If they actually did so, then the parties' participation interest in the breach is satisfied. The lower price that the promisee was offered, and that she accepted, to release the promisor of the obligation to perform in these contingencies is evidence of her participation in the determination of "breach." Under these circumstances, nonperformance (breach seems a misnomer in this context) and payment of expectation damages would be entirely consistent with the promisee's participation interest: the promisee has participated in the decision to release the promisor of his obligation to perform in the contingency at hand, and that participation is reflected in the expressed terms or through some ex ante pricing mechanism.

Now, assume that the parties did not directly anticipate contingencies leading to the cost of the promise exceeding its value. Imagine also that market structures did not account for these contingencies in the price term. The promisee, in this case, cannot be said to have participated in releasing the promisor of his obligation to keep the promise. Her participation interest is not satisfied—yet. Moreover, if the promisor breaches without the participation of the promisee, then the interest can never be satisfied in this case. This would render the moral permissibility of the breach dubious, even

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out of courtesy given the relationship and agreement between the parties—then a failure to undertake this trivial act of courtesy may cause more resentment than an omission requiring greater effort from the plumber.

[34]Even if their particular agreement failed to anticipate the circumstances surrounding breach, it may still be the case that market structures which conditioned the negotiations and the price reached by the parties have accounted for these circumstances, in which we might say that the parties weren't active/direct participants in the release, but they were participants indirectly through their participation in the market. There are reasons to resist this final interpretation. As Seana Shiffrin observes regarding "market pressures [that] force a price calibration[;] whether the ex ante price sufficiently compensates for the potential of deliberate breach depends in part on whether a mere implicit price break could morally compensate for a nonconsensual deliberate breach. This is, in part, what is at issue." Seana Shiffrin, "Could Breach of Contract Be Immoral?" 107 Mich. L. Rev. 1551, 1558, fn. 27.

if it is efficient to breach and expectation damages are fully compensatory.
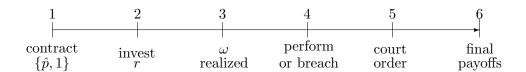
5   Conclusion: A Thought Experiment

I will conclude, inelegantly, with a thought experiment. Even if the promisee placed no value on her interest in participating in the release of the promisor's obligation to perform, might she still demand more than nothing to allow the promisor to self-execute his own release? Imagine that a third party offering the better opportunity to the promisor creates a quasi-Ultimatum game. In the conventional Ultimatum game, a third party (an experimenter) offers two players a sum of money, say one hundred one dollar bills, which the two players can share between themselves only if they can agree on a division of the money. The rules of the game stipulate that one player, the proposer, proposes a division of the hundred dollars, and the other player can either accept the share offered by the proposer or reject it, in which case both end up with nothing. The game is played only once for one round. The economically rational outcome would be for the proposer to offer $1 and keep $99 for herself. The other party is better-off accepting the miserly offer of $1 than getting nothing, which is what would happen if she rejects.

Now imagine some third party approaches a contractual pair and offers them a sum of money beyond the total gains of their present contractual arrangement, but the offer requires that the parties agree to some division of this net gain. To what division would the parties agree? Let's say that their bargaining is structured as it is in the conventional Ultimatum game: the promisor (the proposer) has a single opportunity to offer some division, which the promisee can either accept or reject. If the offer is accepted by the promisee, the promisor is released from his prior obligation and the goods are delivered to the third party, allowing the original contract pair to realize a net gain beyond their contract—a gain which is allotted according the parties' proposed and accepted division. However, if the promisor's offer is rejected, the opportunity presented by the third party is lost forever. What if the promisor proposed to give the promisee $0 of the net gain, offering merely to bring her to the position she would have experienced had the fortuitous interloper not put the greater sum of money before them? That offer would probably be rejected as such low-ball offers usually are rejected in the conventional Ultimatum game. Yet, this division is exactly the one suggested by the efficient breach hypothesis. What would the par-

ties have agreed to had they anticipated the interloper's opportunity and incorporated that contingency in their contract? We might imagine that the promisee would reject the offer (at least 50% of the time, reflecting her indifference between accepting and rejecting it) and receive specific performance or expectation damages, whichever remedial default is appropriate to the case. But, who's to say the structure of counterfactual bargaining around unanticipated efficient breaches would look like the Ultimatum exercise? No one knows. Still, it is not at all obvious that other bargaining environments, such as repeated rounds, would lead to an outcome where the promisee gets none of the gains from the promisor's release and subsequent enrichment. And, if it is not obvious that the parties would have agreed to this division, then the articulated basis for claiming that the promisor's decision to breach and pay expectation damages is not immoral goes away.

A Model Setup

Take the following sequence of events. At time period 1, the parties enter the contract $k_1 = \{\hat{p}, 1\}$, where the risk-neutral seller promises to deliver $\hat{q} = 1$ unit of an indivisible good to the risk-neutral buyer, who pays a price $\hat{p}$ in return upfront, which implies only party, the seller, can breach. At time period 2, the buyer makes a selfish relationship-specific investment $r \in [0, \infty)$, which increases his valuation $v(r)$, but at a decreasing rate— that is, $v'(r) \geq 0$, $v''(r) \leq 0$. At time period 3, nature selects $\omega \in \Omega$, which stochastically determines the good's production cost (note that only the seller's variable costs of production are uncertain at the time of contracting): $c(\omega) \in [0, \bar{c}] \sim F(c)$. At time period 4, the seller makes her decision to breach or perform, $d \in \{0, 1\}$. At time period 5, the buyer takes the seller to court if the sell delivered $d = 0$ (i.e., breached) in the previous period. Final payoffs are realized in time period 6. The timeline below depicts the sequence of events.

Notice that there is no depiction of renegotiation. In this class we will assume that the parties are neither able to renegotiate their contract nor around the court's order. We will relax this assumption later, allowing parties to renegotiate the initial agreement (k_1) by mutual consent at any time and to renegotiate around the court's order between time periods 5 and 6. For now, renegotiation is not possible, ruling out any Coasean bargaining.

B Analysis

The analysis below proceeds in four steps. First, as benchmarks, the first-best trade and investment decisions are derived, as well as the trade and investment decisions without contract. Second, the first-best benchmark is compared to the outcomes under expectation damages, revealing the familiar results of efficient trade, inefficient investment and the ex post gains for

breach going to the seller. Third, a remedy where the seller is denied the gains from breach is considered and the efficiency results are addressed. Fourth, additional remedies are considered.

B.1 Benchmarks

With this basic setup, we can now establish two benchmarks against which to measure the performance of the contract under various remedial regimes. The benchmark is the first-best social optimum (i.e., what the benevolent social planner would dictate). The second is the no-contract benchmark, or what would occur in the state of nature where contractual agreements cannot be enforced by the state or some other capable party.

B.1.1 First-best Social Optimum

The first-best socially optimal outcome has two components: (1) an optimal ex-post trade decision, d^+, at date 4 or later, which is typically referred to as **efficient ex-post trade** or **efficient allocation** and (2) optimal ex-ante investment decision at date 2, $r^\star$, i.e., **efficient investment**. Efficient trade (i.e., allocation) and investment must satisfy the following two conditions:

1. The trade decision d^+ which is the best response to the buyer's investment r is:

$$
\begin{aligned}
d^+(\omega, r) &= \operatorname*{argmax}_d [v(r) - c(\omega)]d \\
&= \begin{cases} 1 & \text{if } c(\omega) \leq v(r) \\ 0 & \text{otherwise} \end{cases}
\end{aligned} \tag{1}
$$

2. The socially optimal investment decision $r^\star$ maximizes the expected social surplus, $w(r, d^+) = E[W(r, \omega, d^+(\omega, r))]$,

$$
r^\star \in \operatorname*{argmax}_r w(r, d^+)
$$

Note that efficiency requires that no trade is made at any cost which exceeds $v(r)$. When cost exceeds value, trade-related investment produces no social surplus because trade is not socially desirable. Social surplus function, $w(r, d^+)$, can then be written as value net costs at every c between 0 and $v(r)$ (which gives us the lower and upper integral bounds in the following expressions):

$$r^\star \in \operatorname*{argmax}_r \int_0^{v(r)} [v(r) - c] \, \mathrm{d}F - r. \tag{2}$$

Assuming that the social welfare function is concave, by differentiating expression 2 with respect to r and setting it equal to zero, we can locate the investment level, $r^\star$, that maximizes social welfare, which is shown in equation below:

$$v'(r^\star)F[v(r^*)] - 1 \;\; = \;\; 0. \tag{3}$$

Hence, the socially optimal trade decision (given first-best investment) is:

$$d^*(\omega) \;\; = \;\; d^+(r^\star, \omega). \tag{4}$$

Recall that $r^\star$ represents socially optimal investment and d^+ represents efficient ex-post trade. In addition, $d^+(r^\star)$ is efficient ex-post trade made in response to socially optimal investment and is called the "first-best" decision. The socially optimal trade decision is first-best. If the trade decision were the optimal ex-post trade decision, d^+, made in response to socially suboptimal investment, $r \neq r^\star$, then the decision would be efficient but not socially optimal (and therefore not first-best).

B.1.2   Benchmark 2: No Contract ($\sim k$)

In a state without contracts, the best possible allocation has two components: (1) efficient ex-post trade decision at date 4, $d_{\sim k}$, and (2) a rational ex-ante investment decision at date 2, $r_{\sim k}$, given the absence of a legally enforceable agreement. Hereafter, assume, that the buyer captures

an exogenously determined share, $\alpha \in [0, 1]$, of any trade surplus and the seller gets the rest, $1 - \alpha$. The following thus describes the no-contract benchmark:

1. As there is no contract, the parties decide ex-post (after uncertainty is resolved), whether to exchange the good or not. Assuming that as rational individuals, the parties they always trade the good when there are gains from trade, i.e., when $c(\omega) < v(r)$, the decision to trade under the no contract condition matches the efficient decision to trade. Therefore, when $c(\omega) < v(r)$:

$$d_{\sim k}(\omega, r) = d^+(r, \omega) = 1. \tag{5}$$

2. Since the trade surplus is distributed according to an exogenously given ratio, with the investing buyer getting a share of $\alpha \in [0, 1]$, it is optimal for the buyer to invest $r_{\sim k}$:

$$r_{\sim k} \in \operatorname*{argmax}_r \alpha \int_0^{v(r)} [v(r) - c] f(c) \mathrm{d}c - r. \tag{6}$$

Since expression 6 is identical to expression 2—that is, aside from the α, which is a constant—it's follows that differentiating 6 with respect to r will give us the following first order condition:

$$\alpha v'(r_{\sim k}) F[v(r_{\sim k})] - 1 = 0. \tag{7}$$

It follows from the concavity of the expected social payoff function that $r_{\sim k} \leq r^\star$, which is the standard holdup result.

B.2   Expectation damages (ED)

In the event of breach, expectation damages require that the seller pay the buyer compensation that makes him whole, i.e., the payment must put the buyer in the same position in terms of utility as if the contract had been performed (which is $v(r) - p$ if the buyer didn't pay upfront and $v(r)$ if he did). Given this, the trade (i.e., allocation) and investment decisions under expectation damages will be determined by the following two conditions:

1. The seller chooses to breach ex post if and only if:

$$p - c(\omega) < -[v(r) - p]$$
$$c(\omega) > v(r).$$

Hence, expectation damages induce efficient breach:

$$d_{ED}(r, \omega) = d^+(r, \omega). \tag{8}$$

2. In equilibrium, the buyer chooses the investment r_{ED} which maximizes his expected payoff:

$$r_{ED} \in \operatorname*{argmax}_r \int_0^{v(r)} [v(r) - \hat{p}]f(c)\mathrm{d}c + \int_{v(r)}^{\bar{c}} [\tilde{v}(r) - \hat{p}]f(c)\mathrm{d}c - r,$$

which, for perfectly estimated expectation damages, i.e., $\tilde{v}(r) = v(r)$, can be rewritten as

$$r_{ED} \in \operatorname*{argmax}_r v(r) - \hat{p} - r. \tag{9}$$

Taking the derivative of expression 9 with respect to r produces,

$$v'(r^\star) - 1 = 0 \tag{10}$$

Comparing equation 10 to equation 3, it immediately follows that $r_{ED} > r^\star$.

Expectation damages induce the ex-post efficient breach decision, but it also induces buyer overinvestment.

B.3 Distributing of the Social Gain from Nonperformance

Recall the discussion from the text, where Δ is defined as the social gain from nonperformance of inefficient contracts, that is, $\Delta = [c(\omega) - v(r)]^+$. Assume that the promisee gets $\Delta - \varepsilon$ of the nonperformance surplus while the promisor get's ε.

B.3.1 Disgorgement-ε Measured Against the First-best

Note that ε is positive only when Δ is positive. Think of ε as some share of any positive breach surplus that goes to the promisor. Now let $\varepsilon \to 0$ such that for any positive real number, δ, it is the case that $\varepsilon > 0$ is strictly less than δ. This remedy is indistinguishable from disgorgement, and I will refer to it hereafter simply as disgorgement, rather than the more cumbersome Disgorgement-ε.

When the remedy available for breach is disgorgement, the court orders the seller to pay the buyer an amount $c(\omega)$, which improves the buyer's investment efficiency and results in allocative efficiency. Allocative efficiency results because the seller, anticipating the court's order, will choose to perform when the buyer's value is greater than her costs. When the seller's cost is greater than the buyer's value, i.e., $\Delta > 0$, the seller gets $\varepsilon > 0$ more from breach

That is, S performs when and only when her payoff from completing the contract is greater than what she gets from breaching

$$
\begin{aligned}
\hat{p} - c(\omega) &\geq -[c(\omega) - \varepsilon - \hat{p}] \\
0 &\geq \varepsilon.
\end{aligned} \tag{11}
$$

Yet when $\varepsilon > 0$, which occurs only when breach is efficient, the seller breaches. Hence, disgorgement induces efficient breach:

$$
d_{D_\varepsilon}(r, \omega) = d^+(r, \omega). \tag{12}
$$

In equilibrium, the buyer chooses the investment r_{D_ε} which maximizes his expected payoff:

$$
r_{D_\varepsilon} \in \operatorname*{argmax}_r \int_0^{v(r)} [v(r) - \hat{p}] f(c) \mathrm{d}c + \int_{v(r)}^{\bar{c}} [c - \varepsilon - \hat{p}] f(c) \mathrm{d}c - r. \tag{13}
$$

The buyer does not get $v(r)$ in every state of the world, but gets $[c - \varepsilon]$ when the seller breaches, hence the buyer's incentive to overinvest is reduced.[35]

---

[35]If the seller were investing, we would have seller overinvestment in the model.

The first-order condition from expression 13 is the following,

$$v'(r)F[v(r)] + \varepsilon \cdot v'(r)F[v(r)] - 1 \quad = \quad 0, \tag{14}$$

which approaches the first-best investment level as $\varepsilon \to 0$.

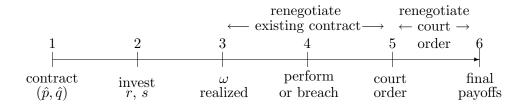### B.3.2 Expectation-ε Measured Against the First-best

Now let $[\Delta - \varepsilon] \to 0$ such that for any positive real number, δ, it is the case that $\Delta - \varepsilon > 0$ is strictly less than δ. This sharing of the social gain from is indistinguishable from the expectation damages remedy in terms of allocation and investment efficiency. The result here is indistinguishable from the conventional results of breach with expectation damages.

B.4 Distributing the Rights of Nonperformance

Any division of Δ such that $\varepsilon > 0$, however small, is consistent with rational actors breaching when breach is efficient and avoidance of inefficient performance whether the promisee has a absolute right to performance or not.

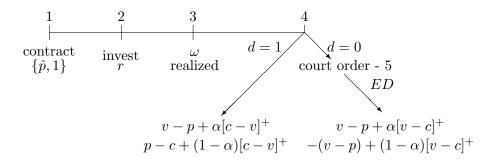## C Adding Renegotiation to the Basic Model

To the basic sequence of events, we now allow the parties to renegotiate the initial contract, k_1, which only makes sense when there is new information and before the court issues a remedy, if one is required. That is, renegotiation of the contract occurs, when it does, between dates 3 and 5. Before date 3, the parties discover nothing they didn't already know when they first entered the contract. Even the buyer's investment at date 2 can be rationally determined ex ante, given the parties' knowledge of the court remedies. It is also now assumed that the parties may bargain around the court's order after date 5. The outcome from such bargaining, both in terms of allocation of the good and the division of surplus, are also entirely predictable (conditional on the realization of ω) at date 1.

renegotiate   renegotiate
⟵ existing contract ⟶ ← court →
order

```
  1          2          3          4          5      6
  ├──────────┼──────────┼──────────┼──────────┼──────→
contract    invest       ω       perform     court    final
 (p̂, q̂)     r, s      realized  or breach    order   payoffs
```

We assume that renegotiation is costless. That is, if performance of the contract or execution of the court order would lead to an inefficient ex-post trade decision—which is to say, if after investments have been made by the buyer, the seller either chooses to breach when trade would be efficient or chooses to trade when breach would be efficient—the parties can costlessly renegotiate the trade decision and divide the resulting renegotiation surplus according to the sharing rule $\alpha \in [0, 1]$ going to the buyer and $1 - \alpha$ to the seller.

C.1 Expectation Damages with Renegotiation

Note that under expectation damages (as well as under the various disgorgement remedies) there is no room for surplus gains through renegotiation. Litigation or the threat of litigation always leads to efficient ex post trade, leaving no surplus to be had from renegotiation. To see this, consider the tree diagram (below) for expectation damages with renegotiation, where the buyer receives a share α of the renegotiation surplus.

```
  1          2          3          4
  ├──────────┼──────────┼──────────┤
contract    invest       ω     d = 1 / \ d = 0
 {p̂, 1}       r       realized    /    \
                                  /  court order - 5
                                 /       \  ED
                                ↓         ↓
           v − p + α[c − v]⁺         v − p + α[v − c]⁺
        p − c + (1 − α)[c − v]⁺   −(v − p) + (1 − α)[v − c]⁺
```

We will make use of the convenient notational convention $[x]^+$ which equals x when $x \geq 0$ and zero otherwise. It is like an absolute value function that is truncated at zero. Thus, $[v - c]^+$ captures the occasions when $[v - c]$

26

is positive and, for cases where the extant trade decision is nonperformance, renegotiation would create surplus. Similarly, $[c-v]^+$ captures the occasions when $[c-v]$ is positive and, given an extant trade decision of performance, renegotiation to nonperformance would create surplus. For renegotiation we needn't both with $[v-c] < 0$ or $[c-v] < 0$ because the parties would not choose to renegotiate for "negative surplus" (indeed, this would mean that the seller's original trade decision was efficient, so renegotiation would not take place).

Again, the Coase Thoerem tells is that with costless bargaining, the parties always renegotiate towards the efficient ex post allocation. For example, if the seller decides to deliver, but delivery is inefficient $(c > v)$, then the parties would renegotiate. The buyer would get a share α of the renegotiation surplus. Knowing this, the seller will breach if and only if:

$$
\begin{aligned}
p - c + (1-\alpha)[c-v]^+ &< -(v-p) + (1-\alpha)[v-c]^+ \\
v - c &< (1-\alpha)(v-c) \\
\alpha(v-c) &< 0 \\
v &< c.
\end{aligned}
\tag{15}
$$

This means that the buyer's expected payoff can be written as the payoff he receives from performance under (which occurs when $c \leq v(r)$) plus the payoffs given breach (which occurs when $v(r) < c$), each weighted by F)the probability of c occurring within a particular interval) minus investment, r:

$$
\begin{aligned}
b(r, \omega, \alpha) = \int_0^{v(r)} [v(r) - p + \alpha[c - v(r)]^+] \, \mathrm{d}F \quad &+ \\
\int_{v(r)}^{c_H} [v(r) - p + \alpha[v(r) - c]^+] \, \mathrm{d}F \quad &- \quad r
\end{aligned}
\tag{16}
$$

However, because the seller trades efficiently (as shown in the expressions leading to inequality 15), no renegotiation takes place. That is, the first

integral is computed when costs vary from 0 to $v(r)$, thus at no time does $[c - v(r)]^+$ exceed 0 in this integral (i.e., no renegotiation surplus there). Similarly, the renegotiation surplus is 0 in the second integral because breach only occurs when $c > v(r)$, which means in those cases $[v(r)-c]^+ = 0$. Thus, the buyer's expected payoff under renegotiation is:

$$b(r, \omega, \alpha) \quad = \quad v(r) - p - r \qquad\qquad (17)$$

which is exactly the buyer's expected payoff in the case where renegotiation is not possible. Therefore, the possibility of renegotiation does not change the parties' equilibrium payoffs. A similar result can be derived for the disgorgment remedies.