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# LET US NEVER BLAME A CONTRACT BREAKER

Richard A. Posner\*

*Holmes famously proposed a “no fault” theory of contract law: a contract is an option to perform or pay, and a “breach” is therefore not a wrongful act, but merely triggers the duty to pay liquidated or other damages. I elaborate the Holmesian theory, arguing that fault terminology in contract law, such as “good faith,” should be given pragmatic economic interpretations, rather than be conceived of in moral terms. I further argue that contract doctrines should normally be alterable only on the basis of empirical investigations.*

## I.

My thesis is that concepts of fault or blame, at least when understood in moral terms rather than translated into economic or other practical terms, are not useful addenda to the doctrines of contract law. I have borrowed this thesis from Holmes, who in *The Common Law* (and later in *The Path of the Law*) drew a sharp distinction between tort and contract law, so far as issues of fault or blameworthiness are concerned.<sup>1</sup> In the case of an accident giving rise to a tort suit, he thought the loss should lie where it fell, that is, on the victim, unless the injurer was at fault, that is, negligent, and the victim faultless, that is, not contributorily negligent. He thus disapproved, in general, of strict tort liability. But a complication in his analysis arose from his belief in “objective” standards of liability; negligence was the failure of the average person to take proper care, even if the defendant was below average in his ability to do so.<sup>2</sup> That belief was not a fatal defect in Holmes’s fault-based theory of tort law, however; as Bernard Williams has reminded us, consequences, and not just states of mind, influence our moral judgments. “[I]n the story of one’s life there is an authority exercised by what one has done, and not merely by what one has intentionally done.”<sup>3</sup> So inability to meet society’s expectations concerning care to avoid inflicting injury can, when injury results, be considered a species of fault.

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1. O.W. HOLMES, JR., *THE COMMON LAW* 107–10, 299–301 (Boston, Little, Brown, & Co. 1881) [hereinafter *HOLMES, THE COMMON LAW*]; O.W. Holmes, *The Path of the Law*, 10 *HARV. L. REV.* 457, 462 (1897) [hereinafter *Holmes, The Path of the Law*].

2. *HOLMES, THE COMMON LAW*, *supra* note 1, at 108–10.

3. BERNARD WILLIAMS, *SHAME AND NECESSITY* 69 (1993); *see also* BERNARD WILLIAMS, *MORAL LUCK: PHILOSOPHICAL PAPERS 1973–1980* 20, 28–30 (1981). This is the pre-Socratic Greek theory of blameworthiness.

But Holmes was wrong to think that the pockets of strict liability in tort law were inconsistent with a fault-based theory of that law. Strict liability is based on recognition that care is too limited a notion of the duty to avoid doing harm. If you keep a lion in your backyard to ward off intruders and he escapes and mauls someone even though you took every precaution to minimize the risk of escape, there is still the question whether the expected costs of keeping a lion (the risk of injury discounted by the cost of the injury if the risk materializes) exceeded the benefits. To classify an activity as “abnormally dangerous,” thus making the applicable tort standard strict liability, is to adjust those costs to exceed the benefits.

Holmes’s theory of contract law is as fault free as his theory of tort law is fault saturated. He thought of contracts as options—when you sign a contract in which you promise a specified performance (supplying a product, or providing a service) you buy an option to perform or pay damages.<sup>4</sup> The option feature is particularly pronounced when the contract contains a liquidated damages clause. You are promising that you will either perform or pay the amount specified in the clause. As long as you pay the damages awarded by the court in the promisee’s suit for breach of contract, whether they are specified in the clause or computed according to the principles of contract damages, no blame can attach to your not performing even if it was deliberate—even if, for example, you did not perform simply because someone offered you more money for the product or service that you had undertaken to supply in the contract and you did not have enough capacity to supply both the promisee and the new, more necessitous customer.<sup>5</sup> You have not *really* broken your promise, because what you promised (though that is not how the contract will have been worded) was either-or: not performance but *either* performance *or* compensation for the cost of nonperformance to the other party to the contract.

The fact that the victim of a breach of contract can sometimes obtain specific performance or some other form of injunctive relief might seem a great embarrassment to Holmes’s option theory of contract. But it is not if we bear in mind that injunctive relief is possible only when the remedy at law—that is, damages—is unavailable. For in such a case the contractual undertaking loses its either-or character; instead of a promise of performance or damages, it is a promise of performance or nothing, and that is not a choice the promisee would have agreed to. In contrast, a *general* entitlement to specific performance would indeed make contract law fault based. A court would not be willing to command a nonperforming party to perform, on pain of civil and criminal contempt and potentially astronomical fines if he did not, without considering whether he was in some sense “at fault” in not performing—whether in other words the costs to him of performing would have exceeded the benefits to the other party. Moreover, a general

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4. Holmes, *The Path of the Law*, *supra* note 1, at 462.

5. See RESTATEMENT (SECOND) OF CONTRACTS ch. 16, introductory note (1981); *id.* § 309.

entitlement to specific performance would thwart some efficient breaches.<sup>6</sup> If *A* breaks his contract with *B* to sell to *C* because *C* will pay more than the harm (which equals damages) to *B* from the breach, the breach increases the social product: *B* is no worse off, and *A* and *C* are both better off. But if *B* is entitled to specific performance, *A* cannot sell to *C* without paying *B* to agree to terminate *A*'s contract with him, creating a bilateral-monopoly situation (of which more shortly).

The option theory of contract also implies that liability for the breach of a contract is strict, that is, that the victim of the breach need not prove fault by the contract breaker (another reason why specific performance can't be the standard remedy for breach). The promise is to perform or pay damages, and so if you choose not to perform—even if you are prevented from performing by circumstances beyond your control—you *must* pay damages. It wouldn't make any sense to excuse you just because the cost of performance would exceed the benefits, for that would make the option nugatory.

Another way to understand this point is to note that an option has an insurance component. If you promise me either performance or some compensation in lieu of performance you are insuring me against the consequences of your nonperformance. As Holmes explained with characteristic directness,

[t]he consequences of a binding promise at common law are not affected by the degree of power which the promisor possesses over the promised event. . . . In the case of a binding promise that it shall rain to-morrow, the immediate legal effect of what the promisor does is, that he takes the risk of the event, within certain defined limits, as between himself and the promisee. He does no more when he promises to deliver a bale of cotton.<sup>7</sup>

You will make such a promise—grant me such an option—if you are the cheaper insurer against the risk of nonperformance. Strict liability for nonperformance reduces transaction costs by optimizing risk bearing (the function performed in the tort setting by formal liability insurance).

The civil law approach to breach of contract is different from the common law approach. Liability is not strict; a party is in breach of his contract only if he “could reasonably have been expected to behave in a different way,” that is, only if he was at fault in failing to perform.<sup>8</sup> And the victim's entitlement (to the extent actually honored) under civil law to specific performance discourages efficient breaches.<sup>9</sup> The duty of good faith—the

6. Ronald J. Scalise Jr., *Why No “Efficient Breach” in the Civil Law?: A Comparative Assessment of the Doctrine of Efficient Breach of Contract*, 55 AM. J. COMP. L. 721, 726–27, 763 (2007).

7. HOLMES, *THE COMMON LAW*, *supra* note 1, at 299–300.

8. Jürgen Basedow, *Towards a Universal Doctrine of Breach of Contract: The Impact of the CISG*, 25 INT'L REV. L. & ECON. 487, 496 (2005) (“[T]he fault principle is often considered to be an indispensable part of the law of obligations in civil law countries.”); *see also* John Y. Gotanda, *Recovering Lost Profits in International Disputes*, 36 GEO. J. INT'L L. 61, 76 (2004). But the practical significance of the doctrinal differences between common law and civil law contract law has been questioned, as I note later.

9. Scalise, *supra* note 6, at 726–27.

common law version of which can, as we shall see, be explained in non-moral terms—in civil law expands to include “[b]ad faith bargaining,”<sup>10</sup> which may not have a pragmatic, nonmoral, justification.

The difference between the common law and civil law conceptions of contract law may be due to the fact that the common law of contracts evolved from the law merchant and the civil law of contracts from canon law.<sup>11</sup> It is apparent which origin is more likely to produce efficient law. There is evidence that common law is indeed superior to civil law from the standpoint of promoting commercial activity.<sup>12</sup>

One might object to the common law rule of strict liability for breach of contract that a contracting party, at least if it is a corporation, either will be risk averse (because its shareholders can eliminate firm-specific risk by holding a diversified portfolio of stocks) or can buy insurance from an insurance company, and so it can have no need for an insurance component in its contracts. But even large corporations often buy a great deal of insurance; the reasons have to do with managerial risk aversion (a large part of a manager’s wealth may be his firm-specific human capital), tax avoidance, and the deadweight costs of bankruptcy.<sup>13</sup> It is difficult, however, to buy market insurance against the risk of being the victim of a breach of contract, because the risk and its consequences cannot be calculated with the actuarial precision that insurance companies insist upon;<sup>14</sup> there is too much heterogeneity among contracts—too much uncertainty about the likelihood and consequences of a breach. The difficulty of insuring against breach of contract has been demonstrated in the current financial crisis by the near collapse of American Insurance Group (saved only by a federal bailout), which through credit default swaps and other devices had offered default insurance on a large scale.

Probing deeper, we can see that strict liability for breach of contract, too, is a sensible default provision, which allows the parties to specify excuses

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10. William Tetley, *Good Faith in Contract: Particularly in the Contracts of Arbitration and Chartering*, 35 J. MAR. L. & COM. 561, 568 (2004); cf. P.D.V. MARSH, *COMPARATIVE CONTRACT LAW: ENGLAND, FRANCE, GERMANY* 65 (1994).

11. Joseph M. Perillo, Essay, *UNIDROIT Principles of International Commercial Contracts: The Black Letter Text and a Review*, 63 FORDHAM L. REV. 281, 308 n.190 (1994).

12. See, e.g., Edward L. Glaeser & Andrei Shleifer, *Legal Origins*, 117 Q.J. ECON. 1193, 1220–22 (2002); Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right*, 30 J. LEGAL STUD. 503 (2001); Salvatore Mancuso, *The New African Law: Beyond the Difference Between Common Law and Civil Law*, 14 ANN. SURV. INT’L & COMP. L. 39, 52 (2008); Simeon Djankov et al., *Debt Enforcement Around the World* 24–25 (Eur. Corporate Governance Inst., Finance Working Paper No. 147/2007, 2007), available at [http://ssrn.com/abstract\\_id=953000](http://ssrn.com/abstract_id=953000). Yet by not distinguishing between liquidated damages clauses and penalty clauses, the civil law expands freedom of contract, although civil law judges do refuse to enforce “clearly unreasonable” damages clauses. Ugo Mattei, *The Comparative Law and Economics of Penalty Clauses in Contracts*, 43 AM. J. COMP. L. 427, 442 (1995); accord *id.* at 441; Lucia Ostoni, Translation, *Italian Rejection of Punitive Damages in a U.S. Judgment*, 24 J.L. & COM. 245, 261 (2005).

13. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 471 (7th ed. 2007).

14. Cf. Alfred W. Cortese, Jr. & Kathleen L. Blaner, *The Anti-Competitive Impact of U.S. Product Liability Laws: Are Foreign Businesses Beating Us at Our Own Game?*, 9 J.L. & COM. 167, 182 (1989).

for failure to perform, such as *force majeure*. There are also default excuse provisions, such as impossibility and frustration, but the justification is economic rather than moral; they allocate risk as the parties could be expected to have done had they negotiated over the issue.<sup>15</sup>

Then too, determination of fault would necessarily be based on matters outside the contract itself, whereas it is highly desirable, in order to minimize the expense and uncertainty of litigation, that most breach-of-contract cases be decided by a simple comparison (made without a trial or even pretrial discovery) of the language of the contract with the fact of nonperformance.

Eric Posner pointed out at the conference at which the papers in this Symposium were first presented that negligence can be discussed in non-fault terms, such as the antiseptic terms of the Hand Formula, and thus could be proposed as a rival to strict liability in contract law without entry into the morality thicket. But if I am right that contracts contain an important element of insurance, and that strict liability for nonperformance also facilitates contract negotiation and minimizes uncertainty, strict liability is a more efficient regime for contract cases than negligence would be.

Strict liability for breach of contract is not logically inconsistent with treating *willful* breaches differently from involuntary ones, as by awarding punitive damages for the former but not the latter. But contract law does not do that, and for good reasons. For what exactly is a “willful” breach? In the usual case of breach of contract the cost of performance to the defendant would exceed the benefit to the plaintiff. The cost might be or might include an opportunity cost, as in my example in which the defendant discovered that he could sell his product to a third party at a higher price than the contract price. An opportunity cost is a real cost. To deem a breach motivated by a desire to avoid such a cost “willful,” and impose punitive damages or order specific performance, would encourage inefficient conduct—providing a product or service to a party (the contract promisee) who valued it less than someone else did.

Of course the three parties involved might bargain their way out of the situation. But that would be a costly bargaining because of the bilateral-monopoly setting. The promisor could get out of the contract only by negotiating with the promisee, and the promisee could extract concessions from the promisor only by negotiating with him. Each party would be pushing to maximize his share of the surplus value that the breach would enable, and such a negotiation is costly and may fail. If it fails, the surplus is lost, and that is a social and not merely a private cost.

There is an element of perversity, moreover, in arguing that efficient breaches, being deliberate rather than compelled, should be discouraged. Efficient breaches are efficient. Involuntary breaches are often inefficient: the promisor miscalculated his ability to comply with the contractual terms to which he had agreed. I am not suggesting that he should be “punished”; but if fault were taken seriously in contract law, he, like a negligent injurer

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15. See, e.g., POSNER, *supra* note 13, at 96–97.

sued in tort, would be thought at fault whereas a party that committed an efficient breach and thus increases the social product would not be.

The common law rule, consistent with the “no-fault” theory of contract that I am defending as a sound positive as well as normative theory, is that punitive damages are not recoverable in breach-of-contract cases.<sup>16</sup> The major judge-made exception<sup>17</sup> is for breaches by liability insurance companies of their contractual duty to defend.<sup>18</sup> Insureds, especially when they are individuals rather than firms (for example, a driver who has injured someone in an automobile accident), often lack the knowledge or resources required to obtain competent counsel. This may doom their defense to a tort suit and even result in a judgment that takes liability for the injury inflicted on the tort plaintiff out of the coverage of the insurance policy altogether. Yet proof of damages in a suit against the insurance company for breach of its duty to defend may be impossible, or at least very difficult, because it would require a comparison of the performance of the insured’s lawyer with the hypothetical performance of the hypothetical lawyer whom the insurance company would have retained or paid for had it acknowledged its duty to defend. And it would require a determination whether, even if a good lawyer would still have lost the case, at least the court would not have made findings that vitiated the company’s duty to indemnify.

The award of restitution in contract cases might be thought inconsistent with the “no-fault” theory of contract that I am advocating. Restitution is normally awarded when the law wants to deter the defendant’s conduct rather than just make him internalize its costs. In a copyright case, for example, the infringer may be the more efficient exploiter of the copyrighted work than the copyright owner, but, if so, limiting the latter to compensatory damages would create a regime of compulsory licensing. Anyone who thought himself the more efficient producer could infringe with impunity, treating the damages that he would owe the copyright owner as a licensing fee. Restitution of the infringer’s profits, by making the infringement worthless to him, forces the would-be infringer to negotiate with the copyright owner, thus preserving the property-rights regime of copyright law.

To award restitution in contract cases, however—other than in cases of rescission, where the object is to return the parties to their precontractual position, which may require one of the parties to give up a benefit it received from the other (perhaps because of mistake, a common ground for rescission), or in extraordinary situations in which for one reason or another compensatory damages would not compensate the victim of the breach—would create a property right in the enforcement of a contract; and that would give rise to the bilateral-monopoly problem discussed earlier. The

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16. RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981).

17. Consumer-protection statutes, such as the Fair Debt Collection Practices Act, frequently provide for the award of statutory damages, which are similar to punitive damages. *See, e.g.*, 15 U.S.C. § 1692k (2006).

18. *See, e.g.*, 2 ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES: REPRESENTATION OF COMPANIES AND INSUREDS § 9:26 (5th ed. 2007).

promisor who had a superior opportunity to that enabled by the contract could not avail himself of it (more precisely, could obtain no profit from seizing the opportunity) without a negotiation with the promisee. The problem is less acute in copyright cases, where often there are multiple potential infringers, who if prevented from keeping profits from infringement will instead compete to obtain a license from the copyright owner.

Consistent with the economics of the situation, the traditional rule was that restitution was indeed not available simply to give the victim of a breach of contract a choice between his loss and the other party's gain. The traditional rule is under pressure, but it is too soon to determine whether it will give way; there is very little case law on the question.<sup>19</sup>

Professors Thel and Siegelman, in their article in this Symposium, discuss what is in substance though not in name restitution as a remedy for breach of contract: the award of windfall damages to middlemen.<sup>20</sup> Suppose *A*, a farmer, agrees to sell seeds to *B*, a seed wholesaler, for \$100, and *B* agrees to resell the seeds to *C*, a nursery, for \$150. Before delivery is due the price of seeds doubles, and *A* breaks his contract with *B* and sells the seeds to *D* for the new market price of \$200. If *B* is able to cover, and honor his contract with *C*, he will incur a loss that he can charge to *A*. But suppose *B*'s contract with *C* contains a clause that allows *B* to terminate the contract without liability. *B* does so, renegotiates the contract, and sells the seeds to *C* at a price that yields *B* the same profit as the original contract would have done. *B* has incurred no loss as a result of *A*'s breach, yet most courts would deem him entitled to obtain damages from *A* equal to the difference between the market price (\$200) and the price in his contract with *A* (\$100). In effect, he receives *A*'s profit from the breach.

But this result is sound, because the breach has not produced an efficiency gain; *A* is selling at the market price rather than to someone who values the seeds more than *B* does. And *B*'s inability to sell to his buyer, *C*, at the agreed-upon price may damage his business relationship with *C* (and perhaps with other customers as well).<sup>21</sup> Moreover, if the market price of seeds had fallen, *B* would have incurred an uncompensated loss by reason of having had to buy them from *A* at the higher contract price, which would limit *B*'s ability to resell at a profit. Thus, what seem "windfall" damages to *B* are really just the outcome of an agreed risk sharing. The expectation of a "windfall" compensates *B* for the possibility that he will have to confer a "windfall" on *A*, depending on which direction the market price moves in.<sup>22</sup>

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19. See the illuminating discussion in Andrew Kull, *Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts*, 79 TEX. L. REV. 2021 (2001).

20. Steve Thel & Peter Siegelman, *Wilfulness vs. Expectation: A Promisor-Based Defense of Wilful Breach Doctrine*, 107 MICH. L. REV. 1517, 1521 (2009).

21. *Id.* (citing VICTOR GOLDBERG, FRAMING CONTRACT LAW 225 (2006)).

22. *Cf. Tongish v. Thomas*, 840 P.2d 471, 476 (Kan. 1992).



Thel and Siegelman suggest another case in which restitution may be an efficient remedy for breach of contract.<sup>23</sup> A building contract specifies a particular brand of pipe; the builder deliberately substitutes another brand, which is just as good but cheaper, and so the builder saves money and yet the buyer is no worse off. This looks like the efficient result, and one wonders therefore why the builder's conduct should be deemed a breach, let alone a willful one requiring a sanction even though the "victim" of the breach has incurred no loss. (Whether it should be deemed a breach with zero damages or not a breach at all is of little consequence.) But as Thel and Siegelman explain, the fact that the contract specified a particular brand may have been intended to curtail the builder's discretion out of concern that any deliberate substitution might well be inferior yet that this might be difficult to prove. Another possibility is that the buyer wanted that brand for some idiosyncratic reason, which a court could not value. In both situations, restitution of the builder's profit from the substitution might be justified.<sup>24</sup>

I say "might" rather than "would" be justified because it can be argued that building contracts are understood by the parties to give the builder leeway to make substitutions in response to changes in the price and availability of the various components<sup>25</sup> and that the buyer is compensated for the builder's freedom by the lower price that the builder will charge in exchange for obtaining such flexibility. The specifications in the contract still are legally enforceable, so that the buyer has a remedy against a substitution that whether or not approved by the architect (and there may not be an architect) reduces the value of the property. But if there is no reduction in value, no damages can be obtained.

My argument thus far may be criticized on the ground that compensatory damages for breach of contract are often inadequate to deter inefficient breaches. That is a common ground for wanting to carve out a class of "willful" breaches and punish them in some fashion, for example by ordering restitution of the contract breaker's profits.<sup>26</sup> But if a supposedly compensatory remedy is not compensatory, then alter the remedy. Yet is that really necessary? The parties are free to specify in advance (within reasonable limits) the amount of damages to which the victim of a breach will be entitled.

I hope I will not be misunderstood to be arguing that there is never wrongful conduct in the negotiation or performance of contracts. I wrote an

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23. Thel & Siegelman, *supra* note 20, at 1526. The case is a variant of *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889 (N.Y. 1921), but there the substitution was inadvertent, and the court said that all the plaintiff would be entitled to was the reduction in the value of his property as a result of the substitution—which was probably zero.

24. See RICHARD A. POSNER, *LAW AND LEGAL THEORY IN ENGLAND AND AMERICA* 55–58 (1996).

25. See RICHARD A. POSNER, *CARDOZO: A STUDY IN REPUTATION* 106 (1990); Todd D. Rakoff, *Implied Terms: Of 'Default Rules' and 'Situation Sense'*, in *GOOD FAITH AND FAULT IN CONTRACT LAW* 191, 209 (Jack Beaton & Daniel Friedmann eds., 1995).

26. See, e.g., George M. Cohen, *The Fault Lines in Contract Damages*, 80 VA. L. REV. 1225 (1994).

opinion recently that presented an interesting example of such conduct.<sup>27</sup> Here is a simplified version. *A* and *B* make a written contract. Later *A* sues *B* claiming that during the negotiations *B* deliberately misrepresented the benefits that *A* would derive from the contract. But *A* does not sue for breach of contract. He can't; the parol evidence rule would bar a claim that promises made during the negotiations but not repeated in the contract should be deemed contractually binding. So *A* sues *B* in tort, charging fraud. The parol evidence rule is not a rule of tort law. But *B* has a defense: the written contract had included a clause stating that neither party was relying on any representations not embodied in the written contract. The "no reliance" clause scotches *A*'s fraud suit because you cannot obtain damages for fraud unless you relied on the fraudulent representations, and *A* has disclaimed such reliance. So although *B* is assumed to have acted wrongfully, *A* has no remedy either in contract or in tort.

Is that a bad result? I think not. Provided (as was true in my case) that *A* is competently represented in the contract negotiations, so that he understands the meaning and significance of such a clause, he gave away his right to sue for fraud, with his eyes open, and presumably was compensated in other terms of the contract for making this concession. (Maybe *he* wanted the no-reliance clause too, because he was worried that *B* might sue him for fraud.)

Neither am I suggesting that moral language never appears in contract cases. Obviously it does, as in the duty of "good faith" in the performance of a contract. But as Holmes explained in *The Path of the Law*, the fact that the law uses moral language doesn't mean that legal duties are moral duties. He famously wished to hold law and morality sharply separate.<sup>28</sup> The law uses moral language mainly because it supplies a familiar vocabulary in which to discuss duties and entitlements and thus provides continuity between legal language and the language of everyday life. To take it literally is a common source of mistakes in legal thinking. Holmes gave examples; here is one that I have heard (albeit at secondhand). A class in an introductory course on contract law was asked why consideration is important in contract law. A student answered that it is because we want the parties to contracts to be considerate of each other's needs and objectives. Admittedly it was a contract course in a business school rather than a law school. But law students and even sophisticated lawyers can stumble over the law's borrowings from moral language to describe legal obligations.

The idea of "good faith" is an example.<sup>29</sup> We generally want people to be honest and aboveboard in their dealings with others. But there is no general duty of good faith in contract law. If you offer a low price for some good to its owner, you are not obliged to tell him that you think the good is

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27. *Extra Equipamentos e Exportação Ltda. v. Case Corp.*, 541 F.3d 719, 722–26 (7th Cir. 2008).

28. See Holmes, *The Path of the Law*, *supra* note 1, at 459.

29. See *Mkt. St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588 (7th Cir. 1991).

underpriced—that he does not realize its market value and you do.<sup>30</sup> You are not required to be an altruist, to be candid, to be a good guy. You are permitted to profit from asymmetry of information. If you could not do that, the incentive to discover information about true values would be blunted. It is an example of the traditional economic paradox that private vice can be public virtue.

And if through no fault of his own the other party to a contract with you cannot perform his duties under the contract, you are not obliged to forbear to enforce your contract rights, even if the result of your hardheartedness is to force him into bankruptcy. You may *want* to forbear, in your self-interest, because creditors don't usually do well in bankruptcy. But if forbearance were *required* by the law, interest rates would be higher because creditors' rights would be diminished.

There is a legally enforceable contract duty of "good faith," but it is just a duty to avoid exploiting the temporary monopoly position that a contracting party will sometimes obtain during the course of performance. More often than not the parties to a contract do not perform their contractual duties simultaneously, and so one party may unavoidably deliver himself into the power of the other party for a time during the performance of the contract. *A* may agree to build a swimming pool for *B*, and *B* may agree to pay *A* upon completion. Suppose that when *A* has finished, *B* refuses to pay the agreed-upon price because he knows that *A* is desperately short of cash and will agree to a reduction in the contract price, having no possible source of cash other than *B*. *A*'s cash shortage, coupled with his having completed performance before *B* has begun and his having no alternative source of cash, gives *B* a monopoly position as *A*'s financier; monopoly is inefficient and so a modification of the contract to lower its price will not be enforced.

I am not using "monopoly" in the sense in which it is used in antitrust law. In my example, the breach is unlikely to have any effect on the market price of swimming pools. But it produces a social loss that can be rectified without an antitrust proceeding, just by refusing to enforce a modification of the contract. So think of the *Alaska Packers* case.<sup>31</sup> Seamen hired for the short Alaska salmon fishing season refused to work unless their pay was increased. The company reluctantly agreed. It had no alternative source of labor to which it could turn; its employees had effectively monopolized its labor supply. (A strike—which is what the case involved—is the exploitation of a temporary labor monopoly.) The court refused to enforce the contract modification, reflecting as it did the seamen's temporary labor monopoly. Courts might describe the seller's conduct in such a case as coercive, extortionate, or in bad faith, but all they would mean by these highly charged words (more precisely all that, for the sake of clarity in law, they should be assumed to mean) would be that an implicit term of every contract (unless disclaimed) is that neither party shall take advantage of a temporary monopoly, conferred by the contract, of the supply of a key input

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30. *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817).

31. *Alaska Packers' Ass'n v. Domenico*, 117 F. 99 (9th Cir. 1902).

into the output of the other party. One can if one wants denounce the temporary monopolist's conduct as wrongful, but the adjective adds nothing to the analysis.

Another example, this one involving the buyer's conduct rather than the seller's, is the rule that reads a "best efforts" obligation on the part of a dealer into the dealership contract if his supplier has given him an exclusive right to sell the supplier's product. Exclusivity gives the dealer a monopoly during the life of the contract, and the best-efforts obligation prevents him from exploiting it. (The benefit of the monopoly to the supplier is that it gives the dealer an incentive to promote the supplier's product; the dealer doesn't have to worry about free riding by competing dealers in that product.) Nothing is gained by describing the dealer who in the absence of a best-efforts duty would exploit the monopoly conferred by the exclusive contract as "blameworthy."<sup>32</sup>

The duty of the victim of a breach of contract to mitigate his damages is also explicable in monopoly terms. A breach creates a bilateral monopoly: the parties would prefer to settle the victim's legal claim rather than litigate over it, but they can do so only by transacting with each other. The victim would like the damages that he has not yet incurred to mount up because that will increase the other party's maximum settlement offer. Suppose the contract entitles him to a million widgets, and the breach occurs after only a hundred thousand have been delivered and he could obtain the rest from another supplier cheaply but the cost to his original supplier of completing performance would be astronomical.<sup>33</sup> The duty to mitigate damages prevents the buyer from exploiting his temporary, contract-conferred monopoly in order to obtain a more generous settlement of his claim of breach of contract.

In all these examples the duty of "good faith" arises after the contract has been formed; that is why it is properly called the duty of good faith in performing a contract. If I may be permitted to quote again from my opinion in the *Frey* case (an opinion I had forgotten before I saw the reference to it in the article by Professors Bar-Gill and Ben-Shahar in this Symposium<sup>34</sup>),

[b]efore the contract is signed, the parties confront each other with a natural wariness. Neither expects the other to be particularly forthcoming, and therefore there is no deception when one is not. Afterwards the situation is different. The parties are now in a cooperative relationship the costs of

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32. *Frey*, 941 F.2d at 596 ("[T]o switch to another familiar example of the operation of the duty of good faith—parties to a requirements contract surely do not intend that if the price of the product covered by the contract rises, the buyer shall be free to increase his 'requirements' so that he can take advantage of the rise in the market price over the contract price to resell the product on the open market at a guaranteed profit. If they fail to insert an express condition to this effect, the court will read it in, confident that the parties would have inserted the condition if they had known what the future held." (citation omitted)).

33. The example assumes that the original supplier could not obtain the needed quantity from the other supplier cheaply, and thus fulfill the contract at little or no increased cost.

34. Oren Bar-Gill & Omri Ben-Shahar, *An Information Theory of Willful Breach*, 107 MICH. L. REV. 1479 (2009).

which will be considerably reduced by a measure of trust. So each lowers his guard a bit, and now silence is more apt to be deceptive.

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... As performance unfolds, circumstances change, often unforeseeably; the explicit terms of the contract become progressively less apt to the governance of the parties' relationship; and the role of implied conditions—and with it the scope and bite of the good-faith doctrine—grows.<sup>35</sup>

There is, however, a limited duty of good faith at the contract-formation stage as well. It reflects the difference between *Laidlaw v. Organ*, where a knowledgeable buyer took advantage of an ignorant seller to obtain a valuable good at a below-market price, and a case of “unilateral mistake,” in which the mistaken party is excused (for *Laidlaw v. Organ* really is a case of unilateral mistake too), discussed by Professor Eisenberg in his article in this Symposium.<sup>36</sup> In the first case, allowing the knowledgeable person to take advantage of the ignorant one has a positive social product; in the second, as Eisenberg argues, it does not. Again I quote, as did Eisenberg, from my opinion in *Frey*:

[I]t is one thing to say that you can exploit your superior knowledge of the market—for if you cannot, you will not be able to recoup the investment you made in obtaining that knowledge—or that you are not required to spend money bailing out a contract partner who has gotten into trouble. It is another thing to say that you can take deliberate advantage of an oversight by your contract partner concerning his rights under the contract. Such taking advantage is not the exploitation of superior knowledge or the avoidance of unbargained-for expense . . . Like theft, it has no social product, and also like theft it induces costly defensive expenditures, in the form of overelaborate disclaimers or investigations into the trustworthiness of a prospective contract partner, just as the prospect of theft induces expenditures on locks.<sup>37</sup>

The promisee's insistence on enforcing the contract with its mistake could be described as wrongful, but (here parting with Eisenberg) I do not see the utility of discussing it under the rubric of unconscionability or in any other morally charged language. I prefer to say that literal interpretation of contracts (specifically, a court's refusal to interpolate any implied terms—implied conditions, as they are rather confusingly described) creates opportunities for parties to extract surplus that the parties would not have agreed to had they foreseen and made provision against such behavior. It is clearer to speak in these terms than to invoke the moral sense.

The forgiving of unilateral mistakes illustrates that even the doctrine of unconscionability, which might seem to pose the sharpest challenge to the

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35. *Frey*, 941 F.2d at 594–96.

36. Melvin Aron Eisenberg, *The Role of Fault in Contract Law*, 107 MICH. L. REV. 1413 (2009).

37. *Frey*, 941 F.2d at 594.

no-fault theory of contract law that I am expounding, may be explicable in nonmoral terms. A further illustration is the doctrine announced by Justice Traynor in *Monarco v. Lo Greco*:<sup>38</sup> if “either an unconscionable injury or unjust enrichment would result from refusal to enforce” an oral promise, a defense based on the statute of frauds will be denied.<sup>39</sup> I wrestled with this doctrine in a recent case,<sup>40</sup> and concluded that the doctrine is best understood as an effort to balance the value of protecting reasonable reliance against the policy that animates the statute of frauds of forestalling contract suits based on fraudulent or mistaken claims of an oral promise. It is not enough that the plaintiff relied on an oral promise; the statute of frauds would be too easily evaded if it did not apply to claims of promissory estoppel. Traynor’s doctrine, I concluded from an examination of the cases, provides a substitute for the evidentiary function of a writing by requiring “a party that wants to get around the statute of frauds to prove an *enhanced* promissory estoppel, and the enhancement consists of a kind or amount of reliance unlikely to have been incurred had the plaintiff not had a good-faith belief that he had been promised remuneration.”<sup>41</sup> The words “unconscionable” and “unjust” conceal the actual character of the doctrine.

## II.

The analysis that I have presented for preserving our “no-fault” regime of contract law is of course not conclusive, but even if it were less persuasive than an analysis that reached the opposite conclusion I would be disinclined to favor changing the law. This is a general point, having nothing in particular to do with the fault issue. It applies to any default rule of contract law. Such a rule is by definition one that the parties can contract around. If they do not do so, or at least do not do so frequently, there is an inference (except in the case of contracts with consumers for inexpensive items) that the rule is optimal. The reason is that the costs of contracting around, in any but the smallest contracts (which is why I am excepting small consumer contracts), are—or so one might think (this qualification will be explained shortly)—small relative to the other transaction costs.

Observation of contracting-around behavior can thus provide an empirical test of the efficiency of a contractual default provision.<sup>42</sup> Given the

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38. 220 F.2d 737 (Cal. 1950).

39. *Id.* at 741.

40. *Classic Cheesecake Co. v. JPMorgan Chase Bank, N.A.*, 546 F.3d 839 (7th Cir. 2008).

41. *Id.* at 845. In *Monarco*, for example, “When the plaintiff reached 18 and wanted to leave home and make his own way in the world, his mother and stepfather promised him that if he stayed and worked on the family farm they would leave almost all their property (which was in joint tenancy) to him. He stayed, and worked hard, receiving in exchange only room and board and spending money. The farm prospered. But when the stepfather died 20 years later, he left his half interest in the farm to his own grandson.” *Classic Cheesecake*, 546 F.3d at 843.

42. See Jeffrey L. Dunoff & Joel P. Trachtman, *Economic Analysis of International Law*, 24 *YALE J. INT’L L.* 1 (1999); William H. Widen, *Corporate Form and Substantive Consolidation*, 75 *GEO. WASH. L. REV.* 237, 263–64 (2007).

availability of this empirical test, it would be imprudent to change the law on the basis of purely theoretical arguments unless the arguments were compelling and hence unrebutted by responsible students of contract law. And that is not the case with regard to the arguments for injecting fault (or more fault) into U.S. contract law.

Granted, studies have found that rules are often not contracted around even if they are inefficient.<sup>43</sup> Some of these studies attribute this result to a psychological bias in favor of the status quo. But such a bias is rational in the contracting process because very few contract disputes result in litigation, so that the transaction costs of negotiating a change in a standard provision will therefore often exceed the benefits.<sup>44</sup> Whatever the reason for the persistence of inefficient default rules, the phenomenon weakens the empirical approach that I am suggesting, but it also exposes an additional reason to go slow in pushing for changes (“reforms”) in contract law. Lawyers and their clients place substantial reliance on the rules of contract law. Even when contracts are individually negotiated, a form contract (which may simply be a form in a lawyer’s office rather than something published in a book of form contracts) is very often the basis for the negotiation, and the form reflects existing law. In addition, contract negotiations and choice of terms (including price) are heavily influenced by the lawyers’ and clients’ understanding of the legal framework. Changing a common law rule creates a period of uncertainty, as courts explore the boundaries of the rule in case-by-case adjudication.

Another reason for proceeding cautiously along the path of contract-law “reform” is the high degree of uniformity in contract law, not only across the fifty American states but also across different legal systems altogether. Although specific performance is said to be the default regime in European contract law and fault does as I have said play a larger role in that law than in Anglo-American contract law, the differences in outcome appear to be small and are narrowing.<sup>45</sup> Civil law judges exercise discretion to award

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43. See, e.g., Omri Ben-Shahar & John A.E. Pottow, *On The Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006); Lisa Bernstein, Comment, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISC. L.J. 59, 71–72 (1993); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998). Cf. Robert E. Scott & Mitu Gulati, *Sticky Contracts (or Why Don’t Law Firms Have R&D Departments?)* (Nov. 8, 2008) (unpublished manuscript, on file with author).

44. This is a possible explanation for contract lawyers’ tendency, noted by Scott & Gulati, *supra* note 43, to swallow their objections to conventional contract terms that may not fit the circumstances of the particular contract in negotiation. In addition, just raising a question about a familiar term may alarm the other party or be taken as a signal that the party raising the question is not committed to the deal or seeks an unwarranted advantage.

45. See Wayne R. Barnes, *Contemplating a Civil Law Paradigm for a Future International Commercial Code*, 65 LA. L. REV. 677, 751–52 (2005); Gotanda, *supra* note 8, at 63–64; Julian Hermida, *Convergence of Civil Law and Common Law in the Criminal Theory Realm*, 13 U. MIAMI INT’L & COMP. L. REV. 163, 167–70 (2005); Barry Nicholas, *Fault and Breach of Contract, in GOOD FAITH AND FAULT IN CONTRACT LAW*, *supra* note 25, at 337; Patricia Pattison & Daniel Herton, *The Mountains are High and the Emperor is Far Away: Sanctity of Contract in China*, 40 AM. BUS. L.J. 459, 475 (2003); cf. Werner F. Ebke & Bettina M. Steinhauer, *The Doctrine of Good Faith in German Contract Law, in GOOD FAITH AND FAULT IN CONTRACT LAW*, *supra* note 25, at 171, 190.

damages rather than order specific performance, and often the same outcomes are reached in common law and civil law systems under different doctrinal rubrics. Thus in answer to a question by Douglas Baird at the conference, Stefan Grundmann explained that civil law courts reach results similar to *Hadley v. Baxendale* under the rubric of a precontractual duty to mitigate damages by requiring the buyer to warn the seller of any unusual damages that a breach would cause.

Global consensus (to exaggerate a bit) is further evidence—of course not conclusive—for the optimality of our existing law. It also suggests the importance, under modern conditions of commerce, of having a degree of global uniformity of contract law. Because there is no international convention on contract law that would make it possible to change the whole world's contract law at a stroke, a change in that law would have to be implemented piecemeal, jurisdiction by jurisdiction; the process of attaining global uniformity would be protracted, and that is another reason to go slow in changing domestic contract law.

Against all this it may be argued, in the spirit of Professor Shiffrin's article in this Symposium,<sup>46</sup> that it is often immoral to break a contract deliberately and that the law should be shaped accordingly, and thus, for example, punitive damages should be allowed in many cases of willful breach. The other side of this coin, presumably, is that a nonperformer should be held in breach of contract only if the breach was willful, opportunistic, or perhaps negligent, but in any event in some way wrongful. I have no wish to debate the morality of contract breaking, but I don't understand the "accordingly." The law does not enforce every violation of the moral code, let alone enforce it to the hilt (as by awarding punitive damages for, or affixing criminal sanctions to, every violation), and I doubt that Shiffrin would want it to. Nor does the law excuse all injuries that are not the result of a breach of the moral code. (Does she want to abolish strict liability in tort?) She needs to give reasons why recasting contract law in moral terms would be a *sensible* step to take and not merely the logical implication of a philosophical theory.

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46. Seana Shiffrin, *Why Breach of Contract May Be Immoral*, 107 MICH. L. REV. 1551 (2009).



