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THE BROKEN PROMISE OF EFFICIENT BREACH: SACRIFICING CERTAINTY FOR FALSE EFFICIENCY

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THE BROKEN PROMISE OF EFFICIENT BREACH: SACRIFICING CERTAINTY FOR FALSE EFFICIENCY
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Give a man a fish and he will eat for a day. Teach him to fish (or to contact) and he will eat for life.  

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1 (Copyright Irma Russell) Irma S. Russell is the NELPI Professor of Law and Director of the National Energy-Environmental Law & Policy Institute, University of Tulsa College of Law. She expresses appreciation for the comments and suggestions of many friends and colleagues on various versions of this article, especially Diane Parrish and Professors E. Allan Farnsworth, Barbara Bucholtz, Nathan M. Crystal, Robert Downs, Gregory M. Duhl, James Fishman, Jeffrey L. Harrison, Robert A. Hillman, Robert H. Jerry, II, Janet Johnson, Janet Levit, Nancy Levit, Peter Linzer, Stewart Macaulay, Thomas McDonnell, Joseph Perillo, C. Scott Pryor, Janet L. Richards, Caprice Roberts, Mark R. Shulman, Franklin G. Snyder, and G. Ray Warner. She thanks the faculty members at Pace Law School and the University of Missouri-Kansas City who attended colloquia on this topic, and she thanks Charles Holliday and Samuel Brown for their research assistance.

2 This old adage speaks generally of the power of process over property as a means of maximizing welfare. Contextualizing the point to the social value of certainty of obligation that is
Efficient breach theory has garnered significant attention among law professors and judges. Moreover, the theory has entered the consciousness of law students and lawyers, providing a general justification for breach and influencing the attitudes and advice about performance and breach of contractual commitments. By the positive adjective “efficient,” the theory purports to identify socially beneficial breaches and, thus, to provide planning benefits through economics, the science of choice. The prospect of distinguishing between efficient breaches and wasteful breaches and setting legal doctrines to apply appropriate incentives promises profound benefits for society. The theory fails to deliver on this promise, however, because it misperceives the essence of contract law as the transfer of resources (goods and services) rather than the transfer of economic rights that maximize the process of trading (contracting). The effect of the theory has been to reconfigure the purposes of contract law and undermine the concept of certainty in contracting.

protected by contract law, it could be stated as follows: Sell a man a fish and he will eat for a day. Protect the right to contract for future fish and protect the expectancy interest of those deals, and the man will fish, sell and buy and markets will flourish.

Although few judicial decisions rely on the theory, courts seem to be accepting some of the assumptions of economics in ways that may lead to further influence of the approach on the law. See Joseph M. Perillo, Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference, 68 Fordham L. Rev. 1085, 1091 (2000) (noting the pernicious effect of the acceptance of the efficient breach fallacy into the legal arena).

Economics has become part of the established terrain of legal thought and has entered a second generation of scholarship in which proponents debate the value of the approach in understanding or critiquing contract law. Professor Eric A. Posner announced the failure of law and economics to explain contract doctrine, attributing this failure to methodological problems rather than to the theory itself. See Eric A. Posner, Economic Analysis of Contract Law after Three Decades: Success or Failure? 112 Yale L. J. 829, 830 (2003) (concluding that economic analysis fails to either explain contract law or to “provide a solid basis for criticizing and reforming contract law” but blaming the failure on “methodological problem involving the concept of transaction costs” rather than on flaws in economic theory). Professor Ian Ayres disputes Professor Posner’s assessment, asserting that economic scholarship provides normative power. See Ian Ayres, Valuing Modern Contract Scholarship, 112 Yale L.J. 881 (2003). Of course in this regard any theory acquires normative power as an incident of its acceptance as a norm.

See http://www.mhhe.com/economics/samuelson17/book/preface_mhtml (visited 5/9/2006) (noting that “at its core, economics is the science of choice”). Richard Craswell, Contract Remedies, Renegotiation, and the Theory of Efficient Breach, 61 S. Cal. L. Rev. 630 (1988). It could be argued that the theory should not be burdened with the task of distinguishing between breaches. The basis of this view is that the determination of the efficiency of the breach is for the parties to determine as they decide whether to perform or breach their contractual obligations. This argument demonstrates the point of this article: that the substance of the theory is an articulation of an attitude about breaching contracts rather than a theory for determining whether a breach is efficient.

One can argue that the role of economics is not to predict or explain contract theory. See Ian Ayres, Valuing Modern Contract Scholarship, 112 Yale L.J. 881 (2003). This argument sets the foundation for judgment for economics and thereby rejects the view of wealth maximization of contract law. Once this conception is accepted contract law will be judged defective as a matter of this norm.

The need for certainty of obligation is axiomatic. It is also clear as a matter of economic analysis. See, e.g., Selmer Co. v. Blakeslee Midwest Co., 704 F.2d 924 (1983) (noting that allowing a party to alter a contract by threats of nonperformance would undermine the certainty of contract and lessen incentives for parties to enter into contracts). I use the term “certainty” to note the societal interest in the performance of contracts, not to suggest that the terms of the contract are in fact certain in an ultimate sense. The Law in
This article does not advocate an adjustment in remedies. It simply analyzes the measure of expectation, taking the measure seriously rather than converting contract doctrine into resource maximization. The default measure of damages for a breach of contract is replacement cost minus contract price. It aims to keep the bargain for injured party. It does not aim to encourage breach. Expectancy is not what a party “expects” but simply a legal term to describe the substitute damage measure. The central thesis of the article is simple: efficient breach theory presents a conception of wealth maximization fundamentally incompatible with contract law. The principle endorsed by contract law is efficient obligation, a principle at odds with efficiency as envisioned by law and economics scholars. While maximizing the wealth of society is central to both contract law and economics, the two regimes present radically different, and ultimately incompatible, approaches to fostering this public good referred to by the terms “efficiency” and “wealth maximization.” Certainty of obligation, the animating principle of contract law, fosters markets in future transactions, encouraging people to make promises of future performance by recognizing the right to expectancy damages. Thus, contract law provides the process for alienating future rights in resources, including the fundamental economic right to reallocate resources efficiently. Analyzing the rule of expectancy in terms of the interest protected and the interest transferred makes clear that the parties to a contract transfer something real: the economic right to allocate resources (locking in or allocating risks and benefits of future performance). The interest protected by the principle of expectancy is the interest transferred by contract -- the economic right to reallocate resources efficiently. This right is protected by securing to the injured party the performance allocated by the contract in the future as set by the parties.

Contract law thus functions to lock in future performance, allowing the parties to gain the security necessary for future planning. Efficient breach theory focuses on the illusion of

Action scholarship makes the point that contracts form a relationship rather than ultimately clear obligations. See Stewart Macaulay, Organic Transactions: Contract, Frank Lloyd Wright and the Johnson Building, 1996 WIS. L. REV. 75; see also email from Professor Stewart Macaulay to author of 1-08-06 (“Suppose that the law were impossibly clear and easy to understand. You would still have to assume that the facts could be found only one way to gain true certainty. We could debate how often this would be possible, but I doubt that you would assert that there would not be a large number of situations where the facts were in doubt.”)

8 Expectancy is the default rule of damages because it preserves the economic right conferred by the contract for the injured party and thereby preserves the certainty that contracts are worth entering in the marketplace. The expectancy measure of damages awards injured party damages to put him in the position he would have been in had the contract been performed. This measure is not the same as “expected profit” or what the injured party “expected” to gain from the contract. An “expected profit” measure would freeze damages at the time of the contract rather than assessing damages based on a substitute performance at the time set for performance. This is not the result of expectancy damages. See UCC 2-712, Restatement (Second) of Contracts § 347.

9 Modern contract law allows the transfer of economic rights as well as products and services. Such transfers include rights that the parties would have otherwise under the law. An agreement to arbitrate disputes results in the sale or alienation of the right to a judicial resolution of disputes. A liquidated damages clause alienates the right to damages by a trial. Forum selection clauses alienate a party’s right to jurisdiction based on the default set by the law.
enhancing the value of the subject matter of the contract.\textsuperscript{10} Claiming that some (undefined) breaches are efficient,\textsuperscript{11} the theory fails to provide a workable definition or test for what breaches fit within the category of efficient breach. The result of the theory’s undefined category encourages breach as a general matter.\textsuperscript{12} As in the story of efficient breach, economics seeks to maximize wealth in the particular transaction under consideration by encouraging movement of a resource to the person who values it most, ignoring the fact that the breaching party has alienated the economic right to reallocate these resources by the original contact.\textsuperscript{13} Contract law, by contrast, seeks to maximize wealth by encouraging contracting itself.\textsuperscript{14} Its incentive of efficient obligation protects the parties’ allocated expectations.\textsuperscript{15} In cases of simultaneous exchange at the time of the original transaction, parties do not need contract law.\textsuperscript{16} By protecting individual rights in promises of future exchanges, it protects society’s interest in encouraging contracting. Efficiency of obligation becomes apparent when one considers the purpose of contract law, the incentives contract law creates.\textsuperscript{17} Taking contract efficiency seriously requires recognition of the full panoply of

\textsuperscript{10} “Scholars identified with the economic-analysis school of legal thought ordinarily make two claims about the relationship between law and economics: (1) the ‘positive’ or empirical argument that legal rules (particularly those of the common law) tend in general to reach ‘efficient’ outcomes and (2) the ‘normative’ claim that ‘inefficient’ rules of law should be modified in the direction of greater efficiency.” Charles L. Knapp, Nathan M. Crystal, & Harry G. Prince, Problems in Contract Law, 11-12 (5th Ed. 2003).

\textsuperscript{11} ‘Law as a guide to conduct is reduced to the level of mere futility if it is unknown and unknowable.’ Justice Cardozo, THE GROWTH OF THE LAW, p. 3, quoted, Securities and Exchange Commission v. Chenery Corp., 332 U.S. 194, (1947), J. Jackson, dissenting.

\textsuperscript{12} See Charles L. Knapp, Nathan M. Crystal, & Harry G. Prince, Problems in Contract Law, 915 (5th Ed. 2003) (noting that some economists argue that the law should “encourage rather than condemn breaches that are efficient”). Efficient breach theorists argue that opportunistic breach should be discouraged. This argument deals with inefficient breaches as a category of opportunistic breaches but fails to delineate the categories.

\textsuperscript{13} Breaching party is the focus of the analysis of efficient breach theory because the concept of public good emanates from a resource perspective, rather than a process perspective. The process perspective of contract damage principles enhances the value of contracting itself, rather than the value of the resources that are the subject of a contract.

\textsuperscript{14} Contract law avoids judging the value of an exchange because it is the exchange of resources that it protects rather than the value of the resources on the theory that resource maximization will take care of itself if the market for promises is protected. The doctrine of consideration ignores the content of a contract and enforces promises on the basis of the deal rather than the value ascribed to performance by the parties. Likewise, contract law disregards the reason for breach except in egregious circumstances such as bad faith or when the breaching party’s conduct also constitutes an independent tort.

\textsuperscript{15} In this context, “expectation” means the in the benefits and risks allocated by the contract rather than “expected profit” or simply what the parties “expected.” See UCC 2-712, Restatement (Second) of Contracts § 347.

\textsuperscript{16} “In a simultaneous, instantaneous exchange there is little reason to promise anything. The making of promises typically concerns deferred exchanges -- that is, transactions that involve the passage of time for their completion.” Robert Cooter & Thomas Ulen, Law and Economics at 184 (2000).

\textsuperscript{17} Contract law and efficiency theory both assert that society benefits from the non-performance of
economic rights, including the ability to alienate the economic right to reallocate resources efficiently. Economics makes the fundamental point that parties have the right to efficiently reallocate their resources. Contract law allows alienation of the economic right to reallocate resources. Parties lock in certainty of obligation with respect to the subject matter of the contract. A breaching party has the power though not the right to reallocate resources (goods or money) that he has allocated by contract. When a party exercises this power in violation of his promise, he seeks to retain the right to reallocate resources in ways he deems efficient. Contract parties do not obtain a full property interest in the resources subject to the contract; they obtain merely the right to the economic benefit set by the contract.

Rather than joining the already well-developed debate relating transaction costs or other issues such as whether specific performance is beneficial, this Article focuses directly on the different concepts of wealth maximization found in the two approaches. It compares the foundational assumptions of economics presented in efficient breach theory and the precepts of contract law, a different brand of efficiency. This comparison reveals the failure of efficient breach theory to explain or effectively critique contract damage principles.

Part II examines some promises. Contract law forgives non-performance in such cases under the doctrines of mistake, frustration and impracticability. Efficient breach theory uses this point of exceptionalism regarding non-performance to undermine obligation generally. Proponents of the theory generalize from the doctrines of mistake and impracticability, undercutting the social utility of obligation generally. See Charles L. Knapp, Nathan M. Crystal, & Harry G. Prince, Problems in Contract Law, 913-15 (5th Ed. 2003) (noting Judge Posner’s use of examples from cases involving impracticability and reminding the reader that a finding of impracticability provides a basis for excusing performance).

The right-power dichotomy is well established in contract and other areas of the law. See, e.g., Jeanne L. Schroeder, "Death and Transfiguration: The Myth that the U.C.C. Killed 'Property,'" 69 Temp. L. Rev. 1281, 1282-1283 (1996) (explaining that buyer under Sections 2-403(2) and 9-307(1), the transferor has the power, but not the right, to transfer ownership in the goods); William L. Tabac, The Unbearable Lightness of Title Under the Uniform Commercial Code, 50 Md. L. Rev. 408 (1991) (noting that in cases in which a party holds provisional title to goods, he has “the power, but not the right, to create indefeasible title in good faith purchasers for value); Fairfax Leary, Jr. & David Frisch, Uniform Commercial Code Annual Survey: General Provisions, Sales, Bulk Transfers, and Documents of Title, 39 BUS. LAW. 1851 (1984) (describing the “entrusting” situation when a recipient has “the power but not the right to divest true owner's title”); Ronald R. Volkmert, Status of Joint Will Determined by Court, 21 Est. Plan. 59, 1994 WL 12153 (W.G. & L.) (1994) (relying on the Hohfeldian terminology to explore the power-right distinction in the context of execution of a new will in violation of a contractual commitment).

By this system, contract law enforces a substitute when the market provides a substitute for the expectancy interest. When the injured party cannot obtain an adequate substitute in the market, contract law grants a property right through the extraordinary remedy of specific performance. This Article refers to the expectancy principle by its traditional name and, additionally, to refocus attention on what the expectancy measures and the interest contract protects, by the terms “allocation” and “run-up” to emphasize the effects of the principle. It uses the term “markup” to call attention to real meaning of expectancy: not “expected profit” but substituted performance, granting markup to capture market shifts. The intent is to renew the traditional concept and combat the modern confusion associated with the term.

Professor Eric A. Posner announced the failure of law and economics to explain contract doctrine, attributing this failure to methodological problems rather than to the theory itself. See Eric A. Posner, Economic Analysis of Contract Law after Three Decades: Success or Failure? 112 Yale L. J. 829, 830 (2003) (concluding that economic analysis fails to either explain contract law or to “provide a solid
the foundational principles of economics and contract law, and the vision of the public good of each regime. It identifies the animating principle of each regime: allocation of economic rights under contract law and maximization of resource value under efficient breach theory. Part III relates the narratives of each regime: the story of efficient breach theory and the reality of legal damage principles. Part IV describes the narrative presented by each regime. Part V explores why the two conceptualizations of efficiency under the two regimes are fundamentally irreconcilable. Part VI concludes that efficient breach theory undermines the brand of efficiency envisioned by contract law because it offers a general justification for breach without a limiting principle, thus fostering a shift in attitude about the conduct of breaching commitments.  

II. Foundational Principles: Beginning at the Beginning

All theories must start somewhere. Each starts from a first principle taken as its animating premise. The foundational principles of a theory limit the theory’s outcomes. Accordingly, it is crucial to understand the basic principles of contract and economic basis for criticizing and reforming contract law” but blaming the failure on “methodological problem involving the concept of transaction costs” rather than on flaws in economic theory). See also Ian Ayres, Valuing Modern Contract Scholarship, 112 Yale L.J. 881 (2003) (asserting that economic analysis has added to the understanding of contract). Economic theory as articulated in efficient breach is based on other errors of logic. First, efficient breach theory uses inconsistent measures. It measures the breaching party’s benefit on a subjective basis while measuring injured party’s value (or damages) by an objective measure. This point is the topic of a separate article by the author: Measure for Measure: Of Apples, Oranges and Efficient Breach Theory. Second, efficient breach theory ignores the inability of breaching party to assess damages or efficiency. Without knowing the substitute price or damages B will incur, S cannot calculate B1’s damages at the time he considers breaching. Accordingly, S cannot know whether B2’s price is high enough to justify a breach. Rather than separating efficient from inefficient breaches or explaining contract doctrine, the theory’s profound effect has been to normalize and justify the decision to breach. Finally, and central to the criticism of the theory explored here, efficient breach theory focuses on valuation of resources rather than the purpose of contracting—obtaining certainty of the benefit of the bargain.

21 The idea that the judgment that a breach is efficient is that of the party to the contract considering breach underscores the point that efficiency presents a shift of attitude rather than a scientific basis for judging contract theory. Indeed Rational Choice Theory holds that whatever the actor chooses is efficient because he has chosen it, essentially stating a tautology.

22 The importance of first principles is illustrated by the story of the turtles. See Roger C. Cramton, Demystifying Legal Scholarship, 75 Georgetown L. J. 1, 1-2 (1986) (telling the story of a confrontation of a scientist and a firm believer: “William James described a classic encounter between scientific truth and a commitment of faith. A prominent scientist had just given a brilliant lecture on the foundations of the universe. During the question period an elderly woman suggested that there was a problem with the professor’s analysis. ‘What is that?’ asked the professor cautiously. ‘It’s all wrong,’ the woman replied, ‘because the universe actually rests on the back of a giant turtle.’ The professor, taken aback, forced, a smile and then countered: ‘If that’s the case there is still the question, what is that turtle standing on?’ The audience tittered, but the woman, undaunted, replied: ‘Another, much larger turtle.’ But . . . ’ objected the professor. ‘I’m sorry, professor, it’s turtles all the way down.’”)

23 Id.
theory to compare the effects of the two regimes. While efficient breach theory and the damages regime of contract law both seek to further the public good, the two approaches present different and fundamentally incompatible conceptualizations of the public good of wealth maximization. Some scholars take this route, implicitly suggesting that the soft fairness or equitable arguments are the answer to the hard “science” approach of economic analysis. From this perspective, setting aside all goals of contract law except wealth maximization would seem to create the system of efficiency described by economics. Contract law is not simply efficiency tempered by fairness, however. The system of wealth maximization conceived by contract law is fundamentally different from efficiency envisioned by economists. Contract law’s vision of wealth maximization seeks to maximize the behavior of contracting rather than maximizing the value of the resources subject to a particular contract. This vision focuses on society’s interest in encouraging contracting rather than the individual’s interest in wealth maximization. The wealth of individuals who contract is enhanced and those individuals benefit from contracting. The societal interest in certainty of obligation, thus, serves individuals as well as society at large. Wealth maximization for society is the effect of the regime. Parties certainly have the right to contract for a limitation of damages to encourage or permit efficient breaches. Whether this avenue has any practical application is questionable since parties are likely to disagree at the time of the breach or nonperformance that the nonperformance is efficient.

Comparing the two conceptions of efficiency requires knowing the starting place of each system. The law mediates the rights of individuals vis-à-vis each other and society, protecting individual members of society and society as a whole. Identifying the basic unit of any regime reveals the start (and, in a sense, the conclusion) of that

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24 Morales v. Schmidt, 340 F.Supp. 544, 549 (W.D.Wis. 1972) (noting the importance of starting points to analysis: "Mindful that the journey's end may well be determined the moment the starting point is chosen, I choose this starting point.")


26 This point relates to law generally. Individuals hold property rights without hiring armies or body guards because of stable governments. Individuals are the beneficiaries of all effective public health and safety regulation. In the area of contract law, wealth maximization by individual market players (in particular and cumulatively) is a derivative accomplishment of the system.

27 Morales v. Schmidt, 340 F.Supp. 544, 549 (W.D.Wis. 1972) (noting the importance of starting points to analysis: "Mindful that the journey's end may well be determined the moment the starting point is chosen, I choose this starting point.")

28 This purpose is clearest in criminal law where the public norms protected are strongest. It is arguably weakest in contract law where the norms function loosely to set the stage for private ordering. Nonetheless, social ordering is an undeniable goal of contract law. This social ordering of contract law can be described as the goal of certainty of obligation.
regime’s analysis and effects. The basic unit is the starting place in the sense that it identifies the element that the regime chooses not to judge. It is the foundation, the bedrock or hardwiring of the theory. Economics will not judge individual subjective valuing. Contract law avoids judging the “deal,” meaning the allocation of the rights transferred. These are the starting places.

A. Contract Principles

Contract law encourages parties to plan for the future by bargaining for a future performance. As a result of contract law, society as a whole gains a significant benefit: the certainty in future markets that allows a modern economy to exist. The risk of market shifts creates the need for contracting. If markets remained constant in supply and price, there would be little need for parties to contract for future performance. Likewise, if the will of individual parties remained constant, there would be no need for contract enforcement. By its damage approach, contract law neutralizes the risk of shifts in the market value of resources and the individual will of the contracting parties. Participants in the real market recognize that market shifts are possible and that the benefit of securing a commitment from the other carries with it the risk of being obligated to perform despite unfavorable market shifts. Predictably, the seller of goods regrets a contract (and is tempted to breach) when the market price of the goods rises. But for the contract, the seller could sell the same goods for a higher price. Conversely, in a falling market the buyer regrets the contract (and is tempted to breach) because he now could buy the same goods at a lower price. Buyers and sellers know this basic point before contracting and accept the risk by entering the contract. Contract damage approach exists to quell the temptation and secure the allocation of risks and benefits set by the parties. The advantage or “take” of a contract to the contracting parties is the surplus of value (each party values the exchanged performance he receives more than the exchanged performance he renders). The advantage or “take” of a contract to society is the surplus of value created in the market at large by the increase in economic activity that results from giving individuals the security to make promises for future performance.

The foundational construct or “given,” of contract law is the “deal,” the agreement of the parties, including its allocation of future risks and benefits. Scholars

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29 Professor Ian Macneil noted this fact in challenging us to “drill down to the fundamentals” of the system. Notes from presentation by Professor Macneil at University of Gloucestershire, 6-8-04.

30 Economics does not “bother with why people desire certain things or whether they should desire those things at all.” Robert Cooter & Thomas Ulen, Law and Economics at 6 (2000).

31 The behavior of contracting is enhanced because the law promises individuals who enter contracts that they will receive performance of promises. Within the terrarium of benefits to groups and individuals, the claim that society can win an advantage by the enhanced value of goods ignores the collateral loss of the allocated benefit to the other individual in the bargain. The loss to the group resulting from the reduction in certainty that contracting is worth pursuing is also of great importance.

32 Economists sought to discredit the classical and elegantly simple bargain theory of contract, emphasizing the exceptions to the rule of consideration. See Robert Cooter & Thomas Ulen, Law and Economics at 179-84 (2000) (using two examples of firm offer in the sale of goods and reasonable
and courts speak of the process of contracting as a matter of binding the will of the promisor.\textsuperscript{33} Neither “will” nor subjective “valuing” is the building block (the basic conceptual component) of the general principle of contract damages.\textsuperscript{34} Rather the building block is the deal: the allocation of risks and benefits to which the parties gave assent.\textsuperscript{35}

\textbf{(1) The Public Good Envisioned by Contract Law: Transferring Economic Rights}

The basic purpose of contract law is one of enforcing promises as a way of serving the public good.\textsuperscript{36} The public good envisioned by contract law is broader than efficiency. “The law seeks to protect reliance and expectancies, and to preserve peace and tranquility. Breaches—even efficient breaches—tend not only to disappoint expectations, but also to precipitate private disputes. The legal system knows what economic science does not know: “Damages and other legal remedies are substitutes for private warfare.”\textsuperscript{37} Indeed, the moorings of promise and commitment are deeply

reliance to assert that the bargain theory of contract is “wrong”). The economic critique of bargain theory shows merely that courts enforce some promises that do not meet the test of consideration. The fact of additional enforceable categories of promises does not invalidate the main force of bargain theory, i.e., that the parties allocate interests based on their bargain and contract law enforces those allocations by the default measure of expectancy.

\textsuperscript{33} Scholars and courts often speak of the process of contracting as a matter of binding the will of the promisor. From the point of view of the individual contract parties, this description may serve a useful cautionary function. In terms of measuring the interest at stake in a contract, the concept of will and the metaphor of binding one’s will hold explanatory power with regard to the default remedy of expectancy than for the extraordinary remedy of specific performance.

\textsuperscript{34} By its prohibition against punishing breaching party, contract acknowledges the power (though not the right) of breaching party to exert his will, to change his valuation of performance, and to breach.

\textsuperscript{35} Of course interpretation is often necessary. The scholarship of Professor Macneil and other scholars provide vibrant points for considering and resolving the content of the full agreement of the parties and the allocation of risks and benefits. The contract may not clearly allocate all risks that ultimately occur during or before performance. The resolution of such uncertainties is the subject of the doctrines of mistake and impracticability.

\textsuperscript{36} Evidence of the transcendent importance of the public good is the fact that courts may refuse enforcement of a contract on the ground that the contract violates public policy.

\textsuperscript{37} Joseph M. Perillo, Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference, 68 Fordham L. Rev. 1085, 1092-93 (2000). Other issues abound. Loss of reputational interests also flow from contracts. The breaching party may experience regret despite his assessment that he is better off breaching. Factoring transaction costs into the formula shows that breaches are not efficient. A wealth of scholarship exists on these points. See, e.g, Henry Mather, Restitution as a Remedy for Breach of Contract: The Case of the Partially Performing Seller, 92 Yale L.J. 14, 23 (1982) (demonstrating that when transaction costs are included breach is not efficient).
embedded in civilized community.\(^{38}\) Even setting aside other purposes of contract law to focus on the single goal of wealth maximization, the system of efficiency envisioned by economic analysis is not the conceptualization of efficiency adopted by contract law. The efficiency goal of contract law is to maximize the wealth of society by encouraging the conduct of contracting, thus, creating robust markets and leading to the increased wealth of society. It also achieves far more protection for individuals than the economics concept of efficiency by protecting the expectancy created by the contract.\(^{39}\)

The freedom to transfer economic rights alone is not sufficient to establish and sustain contracting. Enforcement of promises is necessary to insure the legal effect of transfers necessary to give parties security that their joint decision has legal and thus economic significance. Otherwise, the economic promise has no more effect than the romantic promise to love someone forever. Thus, in the arena of contract, the law creates the security necessary to foster contracting by securing to the parties the benefit of the bargain.\(^{40}\) Contract law does not judge the content of the bargain: a peppercorn will do. This example captures well the judicial restraint necessary for a free market approach. In the same way, it does not judge the content or reason for a breach.\(^{41}\) Rather, contract law focuses on injured party, securing the benefit of the bargain. Keeping the focus on injured party and making that party whole means that breaching party is free to breach. Thus, the task of courts applying contract law is to award damages to protect what injured party received (the expectancy interest). Contract law thus recognizes breaching party’s freedom to breach.\(^{42}\)

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\(^{39}\) To achieve this purpose, contract and property law recognize the legal effect of transfer of title to property upon delivery. Additionally, contract law recognizes the basic right of the economic actor to sell economic rights, including the right to efficiently reallocate resources in the future.

\(^{40}\) Of course the reality of making injured party whole is subject to the deficiencies of damage theory. As a result, injured party will often not be fully compensated. This is one of the issues of contracting set aside by this article to focus on the theory of efficient breach on its own terms. The fact that this issue is not discussed here does not mean that the author believes that damage theory fully compensates injured party.

\(^{41}\) A court may displace this general norm of withholding judgment of the reason for a breach when the court finds the conduct violates a public norm such as the obligation of good faith. See Nicholson v. United Pac. Ins. Co., 710 P.2d 1342, 1348 (Wyo. 1985) (noting obligation to act reasonably in exercising approval and holding deceit can give rise to punitive damages resulting from a breach of the implied covenant of good faith and fair dealing).

\(^{42}\) The damage principle of compensating injured party is not squarely in conflict with the economics conception of breaching party’s choice. The law does not, however, go so far as to endorse a breach. Because of the focus on compensation, economists are able to articulate the law as allowing breaching party to judge his own interests and his own efficiencies. The theory fails to address the loss of certainty in the universe of contracts, however, and creates transaction costs for the system of contracting by increasing the likelihood of breaches.
The thing accomplished by the contract is the alienation of economic rights in future performance. This attribute is necessary to markets because it motivates contracting for future performance. Absent this need of deferring performance to a future point in time, property law would be sufficient. The economic right transferred is not ordinarily the right to demand future performance or require reallocation of resources. Rather, it is the right to the economic benefit from the reallocation. While seller has the power to breach, (perhaps in order to sell to a higher bidder) it is likely that his increased take will be canceled by virtue of B1’s right to the benefit of the bargain, measured by damages. The enhanced value that resulted from market shift (the run-up) is not a resource belonging to S. It was allocated to B1 under the original contract. It is secured to him by the expectancy measure, making the likelihood of an efficient breach a gamble for breaching party.

(2) Wealth Maximization (Efficiency) Envisioned by Contract Law – The Transfer of Rights

Individuals exercise choice in entering contracts. Subjective valuation of the exchange and individual will are implicated in the decision to deal with another in an exchange of resources. Nevertheless, the concepts of valuation and will do not provide the essential building block of the type of efficiency implemented by contract law. Rather, the foundational premise of contract law is the “deal”: the allocation of future rights in performance agreed to in the deal. This foundation is clear from the fact that contract law does not judge the deal. It is the fact of the bargain as opposed to the content of the bargain that provides the legal significance to the parties’ exercise of their joint will to effectuate future commitments. Contract law insulates the deal (the joint action of the parties) from judgment by the concept of consideration. The determination that the bargain is worthwhile is reserved to the joint decision making of the parties rather than to courts. The building block of the deal or the allocation of the contract allows a pact between the parties to transfer the economic interest to allocate one’s resources. That right moves from one contracting party to the other by the contract. The contract allocates the future right or efficient reallocation regarding the resource contracted for. Thus, rather than seeking to maximize the wealth of society on the transaction at issue, contract law seeks to maximize wealth by protecting and

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43 Although contract law does not create a full fledged property right in the parties to a contract, it comes close. It secures the benefit of bargain to the injured party, meaning the allocated potential benefit of locking in the potential benefit as it eventuates in reality. This is less ambitious than conferral of a property right but it is certainly more ambitious than the “expected profit” on a deal.

44 The exceptional case of specific performance includes the binding of the party’s will as the only adequate way to effectuate the bargain.

45 Other scholars have demonstrated the illusory nature of efficient breach theory.

46 By contrast, the “given” of economics is the individual subjective valuing of the actors.

47 The foundational nature of the agreement of the parties to the contract regime is clear from the principle that courts will not judge the value of the bargain.
encouraging contracting itself -- based on the idea that such economic behavior will have
the ultimate effect of maximizing wealth. Contract law does not need to judge the value
or “content” of the promises forming the contract. Indeed, judging the value of the deal
tends away from the foundational principles of free market and free exchange because the
court’s judgment of value would interpose the state between the parties to the contract.

Contract law avoids judging the value of an exchange because it is the exchange
of rights that it protects rather than the value of the resources. It recognizes that resource
maximization eventuates when the market for promises is protected. The doctrine of
consideration achieves this goal by ignoring the content of a contract and enforcing the
basis of the deal rather than the value ascribed to performance by the parties. Efficient
breach theory presents the view that this goal is best served by enhancing the value of
resources. Its rhetoric of valuing focuses attention on the illusion of increased wealth.
While this move appears to enhance value, in reality it merely allows recapture of the
economic right previously transferred by the contract. Thus, the breach does not create
value but merely reassigns market value to the party who contracted it away in the
original contract. Contract law, on the other hand, envisions wealth maximization as a
matter of process rather than resources, respecting the allocation of future benefit
accomplished by the contract.

(3) Efficient Obligation: the Key to the Contract Efficiency (Expectancy is
not Expected Profit)

Under both efficient breach theory and contract law it is essential to identify what
is transferred in a contract to understand injured party’s interest. It is necessary to know

48 This explanation of allocation is paralleled in the concept of consideration in which
contract law identifies enforceable promises not by a judgment that the promises embody value but, rather,
by a judgment that the parties intended a bargain, an allocation of rights.

49 Except in egregious cases, contract law ignores the motivation of a breach. Some
breaches violate more than the private law of the contract to violate social norms such as the prohibition
against anticompetitive conduct or other bad faith conduct. Courts police such conduct somewhat
haphazardly by the standards of good faith and the doctrine of unconscionability. See Brown v. Coats, 253
F. 2d 36 (1958) (approving punitive damages in a contract case and noting that punitive damages are
appropriate where “breach of contract merges with, and assumes the character of, a willful tort”).

50 Likewise, contract law ignores the reason for breach except in egregious circumstances
such as bad faith. Rather than judging the content of the breach or the benefit derived from the breach, it
opts instead for protecting the expectation interest of the injured party. The surrogate for this approach is
the injured party (injured party). Contract law focuses on protecting the expectation of the injured party
rather than limiting the power of a party to breach. In line with this approach, the damage regime of
contract law focuses on putting injured party in the position he would have been had the promised
performance eventuated. This focus creates vulnerability to the claim of economists that contract
encourages breach. Breaching party has the power (though not the right) to breach. As Oliver Wendell
Holmes asserted, the contract obligation means that a party performs or pays. See Joseph M. Perillo,
1085 (2000) (demonstrating that proponents of efficient breach theory misinterpret Holmes' statement
relating to breach).

51 This discussion takes the context of analysis from the efficient breach story of the sale of
what is secured for injured party under contract law to figure damages. Likewise, it is necessary to know this information to apply efficient breach theory because one must know what injured party received by the contract to assess whether the breach leaves him worse off. Scrutinizing the damages principles of law set forth by the UCC makes expectancy clear. The measure of expectancy in contract law is often described as putting injured party in the position injured party would have been in had the contract been performed. It is worth noting that this does not mean that damages should secure for injured party the benefit he "expected" or even what he “reasonably expected.” Rather, it figures damages based on giving the injured party the ability of obtaining a substitute performance at the time set for performance. The market model of damages protects the original buyer by figuring damages as a matter of the market to make that buyer (injured party in this story) whole at the time injured party obtained cover.

Through the use of market price of cover, contract damages capture the value of the contract at the time set for performance. Thus, contract law regards injured party as worse off if he loses his allocated benefit of the contract at issue. The damage formula subtracts contract price from the cover price, securing the goods to B1 (injured party) at the original price by requiring breaching party to pay the differential to current market. It does not require a property transfer to regard the interest of plaintiff as real. The model of damages set forth in the hypothetical stories of efficient breach do not account for this allocated potential change in the market. Rather, the stories focus attention on the “value” of the resources involved in the contract, suggesting that B1’s value is the original price promised by B1. Professor Craswell explains the purpose of efficient breach.

Neither the theory nor this discussion limits the principles to the sale of goods context.

52 See UCC 2-712.

53 This concept of expectancy has been blurred by the focus on maximization of the value of resources. Enhancing resource value is not the direct goal of contract damages though it has the indirect effect of encouraging people to make contracts and, thus, it “promotes the efficient allocation of resources.” Salmer Co. v. Blakeslee – Midwest Co., 704 F.2d 924, 927 (7th Cir. 1983) (Judge Posner, noting the efficient effect of certainty of obligation).

54 The right of the injured party to wait a reasonable time before effecting cover means that this time period is extended somewhat to allow injured party time to make the decision regarding whether to cover. See, e.g., Cosden Oil & Chem. Co. v. Karl O. Helm Aktiengesellschaft, 736 F.2d 1064, (5th Cir. 1984).

55 Efficient breach theory implicitly asserts that damages make injured party whole, meaning no worse off than he would be had the contract been performed. Courts and common sense points out that parties contract for performance rather than merely for the right to bring a lawsuit.

56 This could be either actual damages under 2-712 or theoretical damages under 2-713.

57 Many courts refused to extend enforcement to the “mere expectancy” until modern time. The old enforcement mechanism of quid pro quo required an actual transfer in reliance on a promise to make the promise enforceable. Thus, under that old law, no real interest was recognized when promised in the promise alone.
If a breaching seller must pay damages equal to the value of the goods to the first buyer, the seller will find it profitable to breach the contract only if the second buyer is willing to pay more than that amount. This will be possible only if the second buyer values the goods more than the first buyer does, and in that case the breach will be efficient because it will move the goods to a more highly valued use. 58

Professor Craswell asserts that the opportunity to profit “will be possible only if the second buyer values the goods more than the first buyer does.” 59 Three interpretations of this statement of injured party’s value are possible: (1) the original price, (2) B1’s current subjective valuing of performance, and (3) damages (the objective value to B1). If Professor Craswell’s statement refers to the original price, this presentation locks in B1’s valuation at the time of the original contract and is radically out of step with contract damages under the UCC. Moreover, the price merely sets the minimum value B1 held at the time of contract. If the statement refers to current valuation by B1, it simply declares the value by fiat without seeking this information from B1. If it refers to UCC damages, it must consider the market price to injured party, making the possibility that breaching party will profit from the breach excruciatingly unlikely. 60

Injured party’s expectation interest is not based on a subjective valuation of a performance but, rather, on the cost of a substitute for the performance promised in the contract. This point is clear under the UCC from the fact that B1 does not receive a right to the goods even after the set time of delivery. He lacks right to the goods themselves except when the extraordinary remedy of specific performance applies. If injured party can obtain a substitute in the market, the substitute is his due under the contract. 61 He is entitled to a substitute (money), not the goods. 62 Thus, what he holds by virtue of the

58 Richard Craswell, Contract Remedies, Renegotiation, and the Theory of Efficient Breach, 61 S. Cal. L. Rev. 630, 634-35 (1988). This explanation of efficient breach equates efficiency with B2’s willingness “to pay more than [B2’s damages].” The discussion does not make clear whether B1’s value referenced in the first sentence is the original price of the contract between B1 and S or the damages B1 is entitled to as a result of the breach. No attempt is made to assess B1’s subjective valuing of the goods at the time of the breach or to determine what B1 purchased under the contract. In the statement the “seller will find it profitable to breach the contract only if the second buyer is willing to pay more than that amount,” the reference to “that amount” appears to refer to damages. The next sentence makes the leap to comparing valuing: “This will be possible only if the second buyer values the goods more than the first buyer does.” The “this” of the sentence apparently refers to Seller’s willingness to pay enough to make the breach profitable to Seller.


60 The UCC has increased the availability of goods-oriented remedies, at least for consumers. See, e.g., UCC 2-502

61 See UCC 2-712, 2-713, 2-716.

62 Specific performance is available when the substitute remedy does not put the injured party in the position he would have obtained by performance. This extraordinary remedy applies when the
contract is not the right to the goods themselves (except when specific performance applies), but, rather, the right to a future economic increase in the goods. The security obtained by virtue of contracting for market goods is the expectancy right vis-à-vis the goods, i.e., allocation of the right to any run-up in value that occurs between the time of contracting and the time of performance.63 This is the economic right transferred by the vehicle of contractual commitment; it is the alienation of the economic right of efficient reallocation of resources.

The contract principle of expectancy represents the allocation of risk of future market change. It follows that efficient breach (in the sense of a socially useful breach) occurs only if the price B2 is willing to pay exceeds the run-up in value on the market that B1 is entitled to. In the sale of unique or non-market goods, the parties implicitly agree not only to the sale of goods but also to the remedy of specific performance, thereby excluding efficient breach from the analysis.64 The same sort of analysis could be applied to the sale of market goods, categorizing the future benefits of owning the cotton as the implicit sale and excluding the right of seller to reallocate goods that have been allocated to buyer by the contract.65 What makes clear that efficient breach theory cannot reallocate the run-up back to breaching party is the fact that the run-up or allocation is the thing sold.66 In the ordinary case, (when specific performance is not justified), it is the principal subject of the sale, not merely an incidental subject of the sale. When an adequate substitute performance is available on the market, the expectancy measure secures only the market position of the buyer vis-à-vis those goods at the time set by the contract. Thus, buyer purchased security against an unfavorable shift in price rather than goods per se. The allocation comes with the corollary risk of a fall in price. In a sense, the contract represents an insurance policy against market shift, protecting seller against a fall in price and buyer against a rise in price. It locks in price for each.

The consistent winner in the contract process is society. As a result of contract law, society as a whole gains the certainty in future markets that allows a market cannot provide an adequate substitute either because the goods are unique or not obtainable in the market.

63 The corollary risk of economic loss also attaches. Specific performance may be justified based on a variety of circumstances though the primary issue is whether the market provides a substitute for the performance promised. See Peter Linzer, On the Amorality of Contract Remedies—Efficiency, Equity, and the Second Restatement, 81 Colum. L. Rev. 111 (1981) (noting cases in which specific performance was awarded).

64 See UCC 2-716.

65 This approach falls short, however, because it sets the stage for argument regarding whether the implicit sale should be respected or whether the right of efficient allocation should be seen as surviving the sale, trumping the implicit allocation of rights.

66 That is in the contract in which the extraordinary remedy of specific performance is not appropriate.
modern economy to exist. The UCC damage regime implements expectancy theory. It secures to injured party not the "thing" purchased but the economic right to lock in the price.\textsuperscript{67} Thus each party trades the right to reallocate his resources efficiently for the corollary certainty in getting the market position associated with the resources of the other party.\textsuperscript{68}

Noticing that expectancy damages secure “run-up” for buyer reveals the illusory nature of efficient breach theory. It makes clear that market shifts are neutralized. Each party can set the performance promised by the other at the contract price though each may need to resort to judicial enforcement to secure the promise. Thus, the benefit of an upward shift in a resource (the goods or money) does not belong to the one who holds it when it is committed by the contract to the other. Only when B1 obtains cover in an idiosyncratic deal that is lower than the price paid by B2. Thus, efficient breach theory does not describe a breach that creates value but, rather, one that recaptures value that the breaching party has sold by virtue of the contract.\textsuperscript{69}

The difficulty the party deciding whether to breach faces in figuring efficiency is not happenstance. Nor is it a result of the drafters of the UCC failing to understand “efficiency.” Rather, contract law incorporates the view that what is sold by contract and protected by contract damages is expectancy. Putting B1 in the position he would be in had the contract been performed requires securing to him the run-up of the market. This run-up is not a function of the value B1 placed on the goods at the time of contracting or even at the time set for performance. Rather it is the result of the bargain for the economic right to the resources. It secures the original deal for injured party, awarding to injured party the market differential to secure the goods at the agreed rate and time.\textsuperscript{70}

\begin{itemize}
\item \textsuperscript{67} UCC 2-712 and 2-713 secure the expectation interest in markup rather than the right to the goods themselves.
\item \textsuperscript{68} In Salmer Co. v. Blakeslee – Midwest Co., 704 F.2d 924, 927 (7th Cir. 1983), Judge Posner notes the importance of certainty and the danger of allowing modifications of contracts to undermine the important principle of certainty.
\item Alaska Packers' Ass'n shows that because the legal remedies for breach of contract are not always adequate, a refusal to honor a contract may force the other party to the contract to surrender his rights--in Alaska Packers' Ass'n, the appellant's right to the libelants' labor at the agreed wage. It undermines the institution of contract to allow a contract party to use the threat of breach to get the contract modified in his favor not because anything has happened to require modification in the mutual interest of the parties but simply because the other party, unless he knuckles under to the threat, will incur costs for which he will have no adequate legal remedy. If contractual protections are illusory, people will be reluctant to make contracts. Allowing contract modifications to be voided in circumstances such as those in Alaska Packers' Ass'n assures prospective contract parties that signing a contract is not stepping into a trap, and by thus encouraging people to make contracts promotes the efficient allocation of resources. Id. at 927.
\item \textsuperscript{69} When Seller can supply the goods to B2 at a higher price than B1’s cover and other damages, the parties have the happy accident of surplus that they may share.
\item \textsuperscript{70} The drafters’ choice may also be the result of a belief that indeterminacy creates a preference in the parties for performing rather than breaching. This preference is often stated by the truism
\end{itemize}
The fact that the market price may be seen as the cumulative value of goods by all the bidders in the market does not alter this reality.\textsuperscript{71}

\textbf{B. Economics Principles}

The approach of economics and the law proceeds from an entirely different place. It is situated in the individual perspective. Economics is the study of human behavior of allocating resources to maximize happiness or "utility." The classic definition of "economics" is articulated by Samuelson and Nordhaus as the "science of choice."\textsuperscript{72} Economics evaluates law from the perspective of economic efficiency,\textsuperscript{73} and purports to provide "a scientific theory to predict the effects of legal sanctions on behavior."\textsuperscript{74} Economics has sought to bring the rigor of science to legal theory. Relying on assumptions\textsuperscript{75} -- perhaps a necessary step for any theory-- economics scholars have offered insights into the law, such as external costs and the roles of default rules and mandatory rules.\textsuperscript{76} Perhaps the most significant insight of the approach is the reminder that laws create incentives and disincentives that affect actors in the real world.\textsuperscript{77}

\textsuperscript{71} The orientations of individual valuation versus market price present two sides of the same coin. For planning purposes, the individual transaction is best understood as a response to the market.

\textsuperscript{72} \url{http://www.mhhe.com/economics/samuelson17/book/preface.mhtml} (visited 5/9/2006) (noting that "at its core, economics is the science of choice").

\textsuperscript{73} See David W. Barnes & Lynn A. Stout, CASES AND MATERIALS ON LAW AND ECONOMICS 1 (1992) (introducing the topic by noting that many economists "take the traditional or neo-classical perspective that allocates the benefits and burdens of a legal rule according to a single principle, economic efficiency").

\textsuperscript{74} Robert Cooter & Thomas Ulen, Law and Economics at 3 (2000).


\textsuperscript{76} See Ian Ayres, Valuing Modern Contract Scholarship, 112 Yale L.J. 881 (2003).

\textsuperscript{77} See, e.g., Robert Cooter & Thomas Ulen, Law and Economics at 3 (2000). The strength of legal incentives is open to debate and has been questioned by numerous scholars. Relational theorists suggest that classic contract theory fails to take into account extended commercial relationships, which develop over the course of sequential contracting and argue that economics approach thus overemphasizes the effect of law on contract behavior. See, e.g., Stewart Macaulay, Non-Contractual Relations in Business,
Although some economics scholars purport to defer policy and distributive judgments to policymakers, the structure and momentum of the theory creates a presumption in favor of the economic view and those endorsing the approach set it as the standard for judging the law.

In addition to a scientific theory of behavior, economics provides a useful normative standard for evaluating law and policy. Laws are not just arcane technical arguments; they are instruments for achieving important social goals. In order to know the effects of laws on those goals, judges and other lawmakers must have a method of evaluating laws’ effects on important social values. 78

Of course, any theory has normative force for those who accept its norms. Economic theory centers on conflicts and competing claims among individual right holders. It judges the social effects of legal rules, without analysis of social needs. “The law is designed to resolve the conflicting claims that arise when people interact in society.” 79 Economic scholars recast contract law in the image of economic efficiency: “The purpose of contract law is to enable people to convert games with inefficient solutions into games with efficient solutions.” 80 Economics intentionally withholds judgment of social values except for its endorsement of the value of individual preferences. It does not “bother with why people desire certain things or whether they should desire those things at all.” 81 The fact that “[n]o direct means of measuring utility exists,” creates no problem for the economic approach because each person can be depended on to maximize his own efficiency. 82 This explanation not only co-opts the role of judging the system, it adopts a calculus of individual preferences, ignoring legal norms such as certainty of obligation and, thus, losing the placeholder for collective values. This orientation runs counter to


78 Robert Cooter & Thomas Ulen, Law and Economics at 3 (2000). While it is beyond question that laws are instruments for achieving social goals, it does not follow that economics necessarily provides the vehicle for judging law.

79 Id. While this statement is true, it fails to account for a major goal of the law: providing a way of accommodating the interests of society as well as the interests of individuals.

80 Id. at 187. As a venerable law professor once declared: it’s easy to pull the rabbit out of the hat if you put it in there. Thus, it seems to make perfect sense to judge contract law by economics standards once you accept those standards and define the purposes of contract in terms of those standards. As this article demonstrates, this reframing of contract law does violence to the purpose of contract law.

81 Id. at 6.

82 Id. at 3. This observation has significant force when the preferences observed are preferences of the actors in a scenario. In the case of breach, however, only the breaching party considers his preferences. He cannot fully evaluate the preferences of the other party to the contract. Thus, economics locks in the injured party’s value as the market value. This may or may not be the case, however. The UCC gives credence to the valuing system of the injured party by allowing the injured party to choose between cover and theoretical cover or, in the appropriate case, specific performance.
the major purpose of the law of constraining the rational actor’s decision to act in ways that are contrary to group interests.

Contract law values certainty of obligation. Indeed, it is misleading to say that contract law values certainty in addition to efficiency because the certainty is the brand of efficiency contract law advances. Contract law maximizes resource value indirectly, by maximizing the behavior of contracting. This point is clear from a hard look at the operation of expectancy damages as the default rule of damages for breach of a contract. The goal of wealth maximization of contract law is not based on efficiency as portrayed by proponents of efficient breach theory. To accomplish its basic purpose of stimulating the economic activity of contracting in promises for future performance, contract law trumps the background principle of economics that economic actors have a right to efficiently reallocate resources at any time. This economic right certainly exists. Indeed, it is what is alienated by the contact. Thus, contract law takes seriously the economic freedom of parties in a free market, allowing them to sell the right to efficiently allocate resources in the future in this way, parties allocate future benefits and risks and contract law establishes certainty in markets. Ignoring this sale of an economic right is fundamentally at odds with the social interest in stimulating contracting.

(1) The Public Good Envisioned by Economics: Maximizing the Value of Resources

Economics does not judge the desires of people but, rather, suggests that efficiency means getting the most out of scarce resources by allocating the resources to those who value them most. In economics and efficient breach theory, the foundational principle is the will of the individual, which is expressed as subjective valuation. The basic building block for economics is individual choice and individual valuing. In the rights approach of economics, utility is spoken of as the right to efficiently reallocate one’s resources. The rhetoric of the economic regime protects this right by declaring that the public good depends on its exercise at every point in time. Thus, conduct resulting in an efficient allocation of resources to a more valued use is socially desirable. “For the good of society, resources should be allocated efficiently at every point in time. It is therefore in society’s interest that each economic unit shift its resources whenever this would be efficient.” Because of this grounding, the approach fails to recognize social or collective values, such as certainty of obligation in contract law.

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83 Contract law serves other purposes as well, such as protecting the public peace. See Joseph M. Perillo, Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference, 68 Fordham L. Rev. 1085, 1092 (2000) (noting that legal remedies are substitutes for “private warfare”).

84 Charles L. Knapp, Nathan M. Crystal, & Harry G. Prince, Problems in Contract Law, 915-17 (5th Ed. 2003) (noting that the efficient breach theory encourages breach in some circumstances).


86 E. ALLAN FARNsworth, WILLIAM F. young, & carol Sanger, Cases and
(2) Wealth Maximization (Efficiency) as Envisioned by Economics

One way of articulating the theory of economic efficiency is that it seeks to formulate rules in such a way that the law encourages transfer of resources to the parties who value them most. “[G]enerally efficiency is thought to be increased when the cost of transactions in society is reduced, and resources are allocated to their most highly valued uses.”88 “Scholars identified with the economic-analysis school of legal thought ordinarily make two claims about the relationship between law and economics: (1) the positive or empirical argument that legal rules (particularly those of the common law) tend in general to reach efficient outcomes and (2) the normative claim that inefficient rules of law should be modified in the direction of greater efficiency.”89

Economics incorporates a definition of societal good as the sum of the preferences of all individuals within the society with the requisite funds to express their preferences. "Given a set of individual preferences, the economist argues for legal rules that will help society achieve an efficient allocation of its resources in terms of those preferences."90 The basic unit of subjective valuation of individuals builds the system's conceptualization of the ordering system that best serves the public good envisioned by the system. Economics does not inquire into or judge the reasons for valuation. Economists use terms such as “fancy” or “taste” to convey the subjective nature of valuation in this regime. The link between these terms and Pareto efficiency is the subjective nature of value in economics.91

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87 Efficient breach theorists argue that certainty is important in predicting damages. See Clayton Gillette, Understanding Contract Law: Louis E. Wolcher, The Accommodation of Regret in Contract Remedies, 73 Iowa L. Rev. 797 (1988) (rejecting expectancy to argue for damages to provide a “reliable basis for planning”). They stress the need for fluidity in bargaining in order to best serve maximization and react to changing markets. Of course the reality of a changing market is the very aspect that animates the need for certainty and creates the impulse to hedge against the changing market by capturing a commitment in a contract.


89 Id. at 11-12.

90 Id.

91 Professors Cooter and Ulen explain this point: “A transaction is said to be Pareto efficient if it is impossible to change it so as to make at least one person better off (in his own estimation) without making another person worse off (again, in his own estimation).” Robert Cooter & Thomas Ulen, Law and Economics at 12 (2000) (describing a transaction as Pareto efficient “if it is impossible to change it so as to make at least one person better off (in his own estimation) without making another person worse off (again, in his own estimation”).
(3) Behavioral Assumptions of Efficient Breach Theory

The behavioral assumptions of economists are embodied in rational choice theory, which postulates that doing whatever meets the chooser's ends is rational choice. Under the economic approach, the fact of choice meets the test of rational choice. This point is made by Judge Posner in his explanation of the meaning of "rational choice."

“[L]et me make clear at the outset what I mean by the word [rationality] choosing the best means to the chooser's ends. For example, a rational person who wants to keep warm will compare the alternative means known to him of keeping warm in terms of cost, comfort, and other dimensions of utility and disutility, and will choose from this array the means that achieves warmth with the greatest margin of benefit over cost, broadly defined. Rational choice need not be conscious choice. Rats are at least as rational as human beings when rationality is defined as achieving one's ends (survival and reproduction, in the case of rats) at least cost.” 92

Posner’s explanation emphasizes that rational choice theory is based on individual choice and that the theory does not judge the reasons for the choice. From this subjective perspective, every breach is efficient because it meets the chooser’s ends. 93 The general concept of efficiency takes subjective will as the building block of the analysis (“choosing the best means to the chooser's ends”). 94 It is the starting place of the analysis (and thus influences the conclusion of the analysis). The exercise of will is the event of significance entitled to protection in a system built to maximize individual preference (and consequent social good as a sum of individual preferences). In this system, the determination of public good is built from individual choice, ignoring societal interests that are separate from the sum of the individual preferences. 95

III. The Narratives

A. The Theoretical Story of Efficient Breach

The concept of efficient breach is one of the pillars of economics. Indeed, the concept of “Pareto Superiority” or “Pareto Efficiency” is sometimes explained in terms of the concept of efficient breach. In Law and Economics, Robert Cooter and Thomas Ulen describe the Pareto Superior event: “A transaction is said to be Pareto efficient if it is

93 This point demonstrates the fallacy of circular reasoning of efficient breach theory.
94 Id.
95 Recognition of a societal interest in certainty of obligation means that the Pareto efficiency formula should include the loss suffered by individual members of society by reduction of the certainty of contract by each breach.
impossible to change it so as to make at least one person better off (in his own estimation) without making another person worse off (again, in his own estimation). 96

Efficient breach theory applies this concept to the context of contract law, positing a breach of contract that constitutes socially valuable conduct by making one party (breaching party) better off while making no one worse off, and thus enhances society’s overall wealth. 97 While the theory of efficient breach is told in the context of a sale of goods, the judgment is not restricted to goods contracts. 98 Economics suggests that efficient breach theory explains the contract principle of compensating the injured party rather than punishing the breacher. "The theory of efficient breach asks the question, 'When is it more efficient for a party to breach a contract than to perform as promised?' It also attempts to identify contract remedies and other legal rules that will give promissors an incentive to breach in exactly those cases where breach would be efficient." 99

Scholars advancing efficient breach theory explore the theory in the narrative of a sale of goods, 100 in which the seller has an opportunity to resell the goods for a higher price. 101 What follows is a typical rendition of the event of efficient breach, as told by Professor Farnsworth.

Suppose that S, who values the widget at $90, makes a contract to sell it for $100 to B1 who values it at $110. B2, who values the widget at $130, then offers S $120 for it. What should S do? Our analysis suggests that S should break the contract with B1, pay B1 damages of $10 (the difference between $110 and $100) based on B1's lost expectation, and keep the

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97 The theory fails to measure accurately the loss to the injured party. Moreover, it does not include any factor for the loss to each individual of the certainty of contract obligation or the reduction in the likelihood that parties will perform the obligations secured by the next contract.

98 Although personal services seems to be an area in which subjective judgment has more import, judicial solicitude for the liberty of the party refusing to perform is the pivotal motivating force rather than concern about the quality of the performance or the receiving party’s lack of control over the quality of the performance. In other words, the liberty interest trumps the economic interest. If subjectivity were the pivotal concern, the party seeking to compel performance could dispense with the issue by stipulating that quality is not a concern.

99 Richard Craswell, Contract Remedies, Renegotiation, and the Theory of Efficient Breach, 61 S. Cal. L. Rev. 630 (1988). Professor Posner called this article the “most lucid discussion of efficient breach theory.” See Eric A. Posner, A Theory of Contract Law under Conditions of Radical Judicial Error, 94 NWULR 749 (2000). Nevertheless, the promise of precision in identifying efficient breaches exactly is a spectacular overstatement. Moreover, taking expectancy seriously as the dominant damage principle of contract law makes clear that the incentive of contract law runs counter to the incentive of breaching except in the situations defined by the obstacle doctrines of impracticability and mistake.

100 The economic approach generally casts itself as scientific rather than anecdotal. Nevertheless, the theory rests on a fictional anecdote of a seller and two buyers.

101 This Article accepts this and other articulated assumptions of efficient breach theory in order to assess the theory on its own terms. The only concept of efficient breach theory contested here is the unarticulated assumption that individual valuing is the appropriate measure to be applied to injured party’s interest.
resulting $10 (the $20 difference between $120 and $100 less the $10 damage payment). . . . As long as S, by reallocating resources and selling to B2, will realize more than B1's expectation damages, S's breach is an "efficient" one, one that the legal rules on contract remedies should seek to induce. 102

This hypothetical story of efficient breach theory accepts without question the focus on individual valuing and resource value, defining efficient breach as any breach that benefits breaching party while making injured party no worse off. The theory incorporates breaching party's subjective assessment of whether he is better off, stated (louder than words) by his conduct of breaching. 103 The theory deals with the injured party differently. It determines whether the injured party is worse off, objectively, rather than by his own reckoning. The measure applied to the injured party’s value is either the original contract price promised by the injured party (locking in value attributable to the injured party at the earlier point in time) or the objective standard of market damages. 104 By this formulation, the theory ignores the second part of the Cooter and Ulen test that no person is worse off “again, by his own estimation.” 105 Even with the imperfections of damages, calculation on the objective standard for injured party makes clear that the theory of efficient breach is illusory. 106 The change in market price is the allocated risk, (here called “run-up” to distinguish it from the “surplus” of the original contract). 107 The potential for change in the market (of availability or price) is the reason the parties entered a contract, locking in their interests at the time of contracting. The thing allocated and locked in by the parties is that economic right, the right to efficiently reallocate these resources. 108 Economists recognize this allocative function of contract

102 See Farnsworth and Young, Contracts: Cases and Materials at 21 (5th ed. 1995). Professor Farnsworth notes that the most recent edition of the casebook, Farnsworth, Young and Sanger, Contracts: Cases and Materials at 21 (6th ed. 2001) “deletes the widget example because it tends to suggest that one can commit efficient breaches in typical market situations.” Professor Farnsworth email to the author, May 2002.

103 Voluntary conduct is demonstrable evidence of choice. When two parties choose to contact together, their choice indicates Pareto superiority. In the story of efficient breach, however, voluntary conduct is that of one party only, breaching party. Thus, the story does not present evidence of a Pareto superior event from the subjective assessment of the parties.

104 In this way, descriptions of efficient breach fail to live up to the statement of Pareto efficiency by Cooter and Ulen, indicating that both interests are measured by the same subjective standard. See Robert Cooter & Thomas Ulen, Law and Economics at 12 (2000) (: “A transaction is said to be Pareto efficient if it is impossible to change it so as to make at least one person better off (in his own estimation) without making another person worse off (again, in his own estimation).”)

105 See n. 31, supra and accompanying text.

106 Moreover, the responses of parties in the real world of contracting are not easy to chart. See, e.g., Stewart Macaulay, An Empirical View of Contract, 1985 Wis. L. Rev. 465 (1985).

107 This is the pea in this thimble rig of efficient breach logic. Losing sight of the interest in markup or the right to efficiently allocate resources allows the illusion of increased value.
law generally, 109 but fail to take the effect of allocation into account in the efficient breach scenario. 110 Taking the expectation measure seriously means that the shift in market price referred to here as “run-up” between the time of contracting and the time a party considers breaching involves recognition that the expectation interest to the injured party is the same shift in the market that made the second contract tempting to the potential breaching party. 111

The main character of the story is the breaching party. The focus of the efficient breach story is breaching party’s “take” under the combined transactions. Economics seeks to maximize wealth by insuring that the process of individual valuation (and re-valuation) is respected. Contract law, by contrast, maximizes wealth by reference to contracting itself, as the process of making more wealth by protecting the expectancy interest of the contract. Accordingly, contract law recognizes the right of the economic actor to sell economic rights, including the right to efficiently reallocate resources in the future. An explanation by Professor Craswell draws the focus closer to the real world by its reference to damages.

If a breaching seller must pay damages equal to the value of the goods to the first buyer, the seller will find it profitable to breach the contract only if the second buyer is willing to pay more than that amount. This will be possible only if the second buyer values the goods more than the first buyer does, and in that case the breach will be efficient because it will move the goods to a more highly valued use. 112

108 Another way of expressing this point is that the thing sold by the contract is the allocated risk and benefit of the contract (the expectation interest of the injured party). The principle of expectancy seeks to lock in this allocated right in future performance.


110 Perhaps the terms “expectancy” and “benefit of the bargain” have become shop worn to the extent that economists no longer take seriously the traditional meaning of those terms. The advocacy of economics scholarship converts the meaning of “expectation” and “expectancy” to “expected profit.” This move alters the law in dramatic ways, locking in injured party’s interest to the time of the contract, making the expectations at time of the contract the point for assessing the value of the contract to injured parties. For an example, see Posner, Economic Analysis of Law 131 (5th ed. 1998). Similarly, certainty of obligation morphs into certainty of damages, diluting the power of the law to protect expectation and markets. For an example, see Clayton P. Gillette and Steven D. Walt, Sales Law Domestic and International 338 (2002) (noting the ”costly uncertainty in the application of market price measures to cases of anticipatory repudiation”).

111 It may be that our understanding of the terms is changing subtly in response to the pervasive influence of the philosophy of economics.

112 Richard Craswell, Contract Remedies, Renegotiation, and the Theory of Efficient Breach,
The conclusion that the second buyer values the goods more than the first buyer does not follow from the facts. The story includes an unacknowledged time shift. The information presented relates to the second buyer’s value at the time of his offer. This price is higher, indicating that the second buyer values the goods more than the first buyer valued (or priced) the goods at the time of the original contract. More precisely, the second buyer values the goods more than the price agreed to by the first buyer at the time earlier point in time. Price is merely an indication of parameters of willingness to of a party to pay at a particular point in time not a precise and enduring valuing by the parties. The first buyer may have valued the goods at or above the values ascribed by the second buyer both at the time breach is considered and at the time of the original contract. Efficient breach theory undermines that insurance, allocating back to breaching party the right to efficiently allocate the resources despite the sale of that right by the contract.

B. The Real Event of a Breach of Contract

The real story of the event of breach can be discerned by applying the law of contract damages to the facts of the case. The story and comparison of interests is not based on valuing but, rather, on the allocation of economic rights. Nevertheless, evaluation of the theory of efficient breach is possible by assessing value in the real world context. The role of value ascribed to the case of non-unique goods is best understood in the real world by reference to market value rather than individual subjective preference or abstract valuation. Economic actors value the goods – in the sense of being willing to pay a certain amount for the goods - by reference to what they cost on the market. The goods under contract may be grist for the mill (perhaps literally) or for whatever business a buyer is running. If B1 (injured party) contracted for the goods as raw materials, he needs the raw materials to produce the widget he is making. Likewise, if B1 contracted for goods for his own use, he needs them for that use.

61 S. Cal. L. Rev. 630, 634-35 (1988). This explanation of efficient breach equates efficiency with B2’s willingness "to pay more than [B2's damages]." The discussion does not make clear whether B1’s value referenced in the first sentence is the original price of the contract between B1 and S or the damages B1 is entitled to as a result of the breach. No attempt is made to assess B1’s subjective valuing of the goods at the time of the breach or to determine what B1 purchased under the contract. In the statement the “seller will find it profitable to breach the contract only if the second buyer is willing to pay more than that amount,” the reference to “that amount” appears to refer to damages. The next sentence makes the leap to comparing valuing: “This will be possible only if the second buyer values the goods more than the first buyer does.” The “this” of the sentence apparently refers to Seller’s willingness to pay enough to make the breach profitable to Seller.

113 The contract price reflects the seller’s ceiling on the value. It does not reflect buyer’s ceiling, however. The fixed price contract gave injured party insurance against this shift or run-up in price.

114 These two views of value are opposite ends of the same entity. Are markets the accumulation of all individual preferences or do individuals accept market price as necessity of purchasing? We can contemplate this puzzle in the nature of chicken-egg or tail and dog. It is clear, however, in the individual case that the market is more controlling than individual preferences. The fact that a buyer may value goods at higher than market price does not mean he will volunteer to pay more than the market price.
Valuation is relative to time and instrumental rather than abstract. If B1 contracted for widgets to sell to a subsequent purchaser, his “take” on the transaction will be profit on the resale contract. The expected profit is not buyer’s expectancy damages, however. For expectancy, contract law looks to the market at the time of breach. Contract law uses the market measure of damages as the way of putting the injured party in the position it would have been in had the contract been performed as promised. Under contract law (as opposed to the economic theory) damages are not linked to valuation but, rather, to the market and the deal by the benefit of the bargain measure. Use of this measure reveals the illusory nature of efficient breach theory.

An assertion that B2 values the goods more than B1 (injured party) is not a defense to a claim of breach. Contract remedies include two situations: (1) when substitute goods are available in the market and (2) when they are not. The contract remedy in the first situation is substitution damages and, in the second, specific performance. In the ordinary case, i.e., where the extraordinary remedy of specific performance is not justified, damages will be either cover damages or hypothetical money damages (theoretical cover). Thus, by covering, injured party can obtain the goods in the market, securing his expectation by obtaining the damages for the differential between the contract price and the cover price. If injured party decides not to cover, he can obtain theoretical damages.

115 Viewed by another (consistent) perspective, the fact that B1’s valuation of the widget changes over time does not mean that the law should require him to pay more for the widget than the original contract price. After all, the pricing mechanism of the contract allocated the risk of a rise in the market price to Seller. Such allocation of risk relating to pricing is the primary function of contracting for market goods.

116 The term “expectation” leads some students and even lawyers to assume that the expectation measure captures what the injured party “expected” to gain from the transaction. This is a mistaken view of the benefit of the bargain measure called “expectation.”

117 Seller’s failure to deliver the goods in accordance with the contract is deemed a breach without regard to Seller’s motivation or reason for breaching. Seller may successfully defend against a claim of breach based on excuse doctrines such as impossibility and mistake. Economic contract theorists draw from the realm of obstacles to performance (frustration and impracticability) to justify the ordinary breach. In making the case that some contracts should not be performed, Richard A. Posner justifies efficient breach generally. See Richard A. Posner, Economic Analysis of Law, 131 (5th Ed. 1998) (noting cases appropriate for excuse of performance on the basis of impossibility or impracticability to justify breach in general).

118 A third situation not implicated in this discussion is the decision of the injured party to opt for theoretical cover by seeking damages under UCC 2-713.

119 See UCC 2-712.

120 See UCC 2-713. Goods for which no markets exist either because they are unique goods or so scarce that injured party is unable to obtain cover are the appropriate subject of a decree of specific performance. See UCC 2-716 and comment 2. It is possible that, in some circumstances, the aggrieved party will have no damages or may even be benefited by a breach. See Acme Mills & Elevator Co. v. Johnson, 133 S.W. 784 (KY. 1911) (awarding no damages where contract price was higher than market price at time buyer learned of breach).
The efficiency of a breach cannot be reliably assessed as a way of deciding whether to breach because the injured party's remedy is not known at the time of breach. The remedy depends on what transpires after the breach. The breaching party cannot elect a remedy for the injured party or lock in the remedy. Accordingly, the damages subtracted from breaching party's increased “take” cannot be loaded into the efficiency formula at the time breaching party assesses whether to breach.\textsuperscript{121} In the extraordinary case when a substitute is not available on the market, contract law requires delivery of the goods under a decree of specific performance.\textsuperscript{122} Different points in time may determine the amount of damages, including the time of the breach, the time of cover, or a commercially reasonable time after breach.\textsuperscript{123} None of these can be accurately assessed prior to breach, however.

Efficient breach theory lacks utility as a planning tool for breaching party because breaching party does not control the remedy, and the assessment of efficiency depends on inclusion of this figure in the calculations to determine whether the breach makes him better off. Breaching party seeks a higher “take” on the sale, but this breach is efficient in terms of this goal only when breaching party finds a second buyer who is not a rational actor or is in exigent circumstances, such as inability to obtain goods elsewhere at market price. Under UCC damage rules, the economic run-up of the goods is secured to the injured party, thus the economic benefit of the second sale is canceled out by damages owed the injured party. In the event that market scarcity extends to B1 as well as B2, making a substitute purchase unavailable, the UCC provides for specific performance for B1, clearly extinguishing the benefits breaching party envisioned.\textsuperscript{124}

Scrutiny of B2 suggests that, although efficient breach theory purports to be a theory of general applicability, it is an outlying theory that simply posits the idea of the good breach without defining or identifying this category of breach. The fact that the

\textsuperscript{121} The attribute of uncertainty has drawn criticism on the basis that uncertainty makes it difficult for parties to know when a breach is efficient. See Clayton P. Gillette and Steven D. Walt, Sales Law Domestic and International 338 (2002) (noting the “costly uncertainty in the application of market price measures to cases of anticipatory repudiation”).

\textsuperscript{122} The clear case involves unique items such as works of art. Other cases of inability to obtain a substitute may arise even though the goods may not be unique. See, e.g., Sedmak v. Charlie’s Chevrolet, Inc., 6222 S.W.2d 694 (Mo. Ct. App. 1981) (awarding specific performance for a limited edition 1977 Corvette “Indy Pace Car” because of near impossibility of finding substitute); Curtice Bros. Co. v. Catts, 66 A. 935 (N.J. Ch. 1907) (awarding specific performance for outputs contract to sell entire tomato crop because of uncertain market).

\textsuperscript{123} See, e.g., Cosden Oil & Chem. Co. v. Karl O. Helm Aktiengesellschaft, 736 F.2d 1064, (5th Cir. 1984).

theory seeks to encourage breaches while failing to define the breach to be encouraged ex ante has drawn criticism. The breaching party can not control or plan for the actual damage figure that will be awarded to B1 or for the possibility that B1 (being unable to cover in the market) will be entitled to the goods themselves. Thus, S cannot calculate B1’s damages at the time he considers breaching. Without establishing this figure (B1’s losses) S cannot know whether B2 is offering a sufficiently high price to make it profitable to breach. This exploration of contract remedies demonstrates that efficient breach theory overestimates the ability of breaching party to assess the efficiency of his decision to breach, making use of the theory prior to the breach unreliable.

IV. Comparison of the Theoretical Story and the Actual Event of Breach

Explanations of efficient breach theory suggest that breaching party can decide whether to breach by considering whether B2 will pay enough to offset B1's damages. This suggestion is clear from the Farnsworth and Craswell explanations quoted above. Under the UCC, breach is efficient only if B2 is willing to pay an amount greater than the original price plus damages, with the damage figure remaining unknown at the time of the decision to breach. Injured party Buyer (B1) may cover and sue for damages based on the cover price. If B1 covers, he obtains substitute goods at the original price set by the contract via UCC 2-712 (ignoring transaction costs). Thus, the formula for a breach demonstrates the incentives set by contract law. If D is the difference between the market price at which B1 covers, and P is the original contract price, seller will, in Professor Craswell’s terms, “find it profitable to breach“ only if B2 is willing to pay the original price plus damages plus an amount necessary to insure against Seller’s risk of Buyer successfully making the case for specific performance, plus some additional amount necessary to make the transaction worthwhile to Seller. Thus, the formula for efficient breach theory under the real law must factor in not only damages but also risk of specific

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126 Certainty of obligation is not the same thing as certainty of damages. Indeed, certainty of damages necessarily reduces certainty of obligation under the current damage regime because, as economists have made clear, contract damages under the current structure are imperfect, leading to under compensation of plaintiffs.

127 See footnotes 32 and 41 supra and accompanying text.

128 The damages here will be either cover under 2-712 or theoretical cover under 2-713.

129 The measure of damages often does not fully compensate injured party because it fails to include the transaction costs of collecting damages. For example, the injured party must pay for the attorney’s fees incurred as a result of pursuing damages against the breaching party. Thus, as a practical matter the UCC regime under-compensates plaintiffs. Other works establish the failure of the UCC measure to compensate injured party buyer fully.

130 If the market is lower than P, B1 arguably incurred no damages as a result of the breach. In such a case, B1 may be entitled to consequential and incidental damages.

131 See Craswell, supra.
performance based on market scarcity and some mark up to make the additional transition worth the breaching party’s effort and attention. \( NP > P + D + R + HR + M \), where \( NP \) = new price, \( P \) = original price, \( D \) = damages, \( R \) = the risk of specific performance, \( HR \) = heightened risk of breach by the next contracting party by virtue of greater acceptance of efficient breach theory, and \( M \) = markup in price. \(^{132}\) How much greater the second offer must be to justify breach will depend on numerous factors including reputational interests, the possibility that defendant may wish to do business with B1 in the future, and whatever additional sum is necessary for S to find it profitable to breach the first contract.

Determining an efficient breach prior to the act of breaching is subject to numerous uncertainties. In large part it depends on assuming that B2 is not a rational actor, i.e., B2’s willingness to pay a price in excess of market depends on B2 failing to act rationally. While it is possible that B2 may be experiencing exigent circumstances that necessitate a purchase at a price higher than market price, such exigencies may also affect the market price when B1 seeks cover. Thus, the existence of scarcity which raises the price B2 is willing to pay simultaneously raises the damages and makes specific performance a possibility. This reality destroys the efficiency of the transaction for the breaching party. \(^{133}\)

Multiplying uncertainty, efficient breach theory heightens the likelihood of exigencies by making markets less reliable and undermining contract law’s primary goal of enhancing certainty of markets. S incurs the risk that the market conditions that influenced B2’s higher than market offer may affect B1’s access to substitute goods. If B is willing to pay more than the first contract price it is likely that the market price of the goods has risen. If scarcity exists such that B2 wants the good at a higher price, that scarcity may also affect B1’s cover price. Additionally, such scarcity increases the likelihood that B1 will be unable to cover and, thus, will be entitled to specific performance because no substitute transaction is available to B1. Thus, a situation of exigency that may seem to create value for breaching party (by virtue of B2’s need) is likely to affect B1’s damages, canceling the gain the market rise seemed to hold for S.

The following reformulation of the assessment of a breach is adapted from Professor Farnsworth’s explanation of efficient breach theory quoted above. \(^{134}\) This adaptation establishes the illusory nature of efficient breach by incorporating the damage formula of the UCC into the assessment of breach made by breaching party in the story told by Farnsworth.

\(^{132}\) In the case of market scarcity, and neither sale included a contingency, S is liable to both B1 and B2 and may owe each specific performance.

\(^{133}\) Interpretation of the law in a way that makes breach more likely also makes the situation of exigent circumstances more likely. In this way, efficient breach theory, by the likelihood of breach (as efficient breach theory does), makes the likelihood of a need for performance at higher than market price also more likely.

\(^{134}\) See footnote 41 and accompanying text, supra.
Suppose that $S$ sells a widget to $B_1$ for $100$. We cannot know with certainty the value each party holds for the widget, but we can be confident of value within certain ranges revealed by the price agreed to. $^{135}$ $S$ must value the widget at some price more than $0$ and less than $100$ (otherwise why bother with the effort expenditure of transfer). $^{136}$ $B_1$ must value the widget at more than $100$ (otherwise why bother to write the check). Let’s put his value at $101$ to $1,000 to emphasize the irrelevance of his valuing of the widget to contract law. $B_2$ offers $S$ $120$ for the widget. Again we can be confident of the lower limit of $B_2$’s value of the widget but we can only speculate regarding the upper limit. To be consistent with the original example, let’s say $B_2$ values the widget at something between $121$ and $1,000. (Because the individual subjective value at the high end is irrelevant under contract damage theory, it does not matter whether $B_1$ or $B_2$ holds a higher subjective value for the goods.) What should $S$ do? Our analysis suggests that $S$ should not break the contract with $B_1$, because his gain will in all likelihood be canceled by the damages he will need to pay to $B_1$. Formulating this suggestion from the other perspective, $S$ should breach and pay $B_1$ the damages $B_1$ is entitled to under the UCC and make a profit if (and only if) the cover price $B_1$ pays is sufficiently lower than the differential between the two contract prices ($120-100$) to make the breach profitable to $S$. That is, $S$ should breach only if $B_1$ will cover under UCC 2-712 or obtain theoretical cover under 2-713 at less than $120$. The likelihood that $S$ will profit is excruciatingly small. Moreover, it is unknowable at the time he breaches. The opportunity depends on future developments in the market. $B_1$’s lost expectation is not defined by the value he placed on the widget. Let’s say he valued it at the lowest realistic figure ($101$). $B_1$ is, nevertheless, entitled under contract law to cover at market price and recover the difference between the contract and the cover price even if his subjective value is less than market price. The UCC protects $B_1$’s bargain by the expectancy measure, making $B_1$’s valuing of performance irrelevant. If $B_1$ makes reasonable cover at $120$ or any price greater, the breach is not profitable to $S$. If $B_1$ covers at something less than $120$, the breach may or may not be profitable to $S$, depending on incidental and consequential damages. $^{137}$ If the breach appeals to him only to the extent that it nets a larger profit for him, $S$ must also factor in the risk that $B_1$ will not be able to cover and, thus, a court will decree specific performance.

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$^{135}$ The valuation of the parties is none of our business from the perspective of contract law. Indeed, this valuation may constitute a property right that deserves protection, such as confidential business information.

$^{136}$ This story is beginning to sound like a late night TV. ad selling new cars at $1.00 over invoice where the viewer is encouraged to believe that the invoice represents seller’s costs.

$^{137}$ $S$ may or may not be happy, based on the result - even without regard to whether he made or lost money on the combined transactions. $S$, a rational actor, may have other reasons for breaching than the profit or loss on a deal. In other words, there is room even in this situation to claim efficiency (whatever the result of the math regarding profit) based on Judge Posner’s point about rational actors choosing their own ends. The remainder of the story retold above assumes that $S$ hopes to maximize profit rather than some other utility on the combined transactions.
He should also factor in the increased likelihood of a breach by the second buyer flowing from economic analysis of the next player. Contract rules seek to protect the injured party’s run-up and, thus, to protect contracting at large.  

V. Two Conceptions of Wealth Maximization

A. Different Circles in the Sky

If we take “efficiency” to mean maximization of the wealth of society, it is fair to say that both contract law and economics present a conceptualization of efficiency. Both are “circles in the sky” in the sense that they are theoretical constructs of the public good in terms of wealth maximization. While both theories address other issues, efficiency in the sense of wealth maximization, is the goal of each approach. After setting aside the other community values of contract law to look only at efficiency in this sense of maximizing wealth, the foregoing discussion demonstrates that contract law and economics describe radically different visions of wealth maximization. Indeed the two theories are fundamentally at odds. They cannot be reconciled without adjustment in the basic premise of one or the other. A Venn diagram of the two systems presents separate, non-intersecting circles. Efficient breach theorists seek to maximize the value of the resources, maximizing wealth by enhancing the value of the resources contracted for. By contrast, contract theory advocates maximizing wealth by encouraging the next contract (and all the next contracts), i.e., maximizing wealth by encouraging contracting and establishing a market in which parties have sufficient confidence in contracting to engage in deals for future performance.

Many scholars reject efficient breach as either a descriptive or a normative tool. Some explain that economics is based on flawed assumptions about markets and human

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138 The author revises the story of efficient breach by using the narrative from the Farnsworth casebook explanation quoted above, substituting contract damage principles for economic valuing language.


140 Although I acknowledge the conceptual nature of each regime, it should be obvious to the reader by now that I do not regard the choice between the two as nugatory. My view is that contract law serves the public interest by honoring commitment and that loss of this feature of contract law will make society poorer in many ways.

141 Contract law serves other purposes as well as is noted by Professor Ian Ayers and others. See, e.g., Ian Ayres, Valuing Modern Contract Scholarship, 112 Yale L.J. 881 (2003). The goal of efficiency is the focus of this inquiry.

142 Although both regimes seek wealth maximization, the formulations are so fundamentally different that they describe different types of heightened value: maximized resources or a market maximized by certainty.

143 Contract law’s goal of certainty is noted by many scholars. See, e.g.,
conduct.\textsuperscript{144} Others note that the economics approach fails to give due consideration to other values of society and contract law.\textsuperscript{145} These critiques elucidate significant flaws in the economics approach as applied to contract law. They do not identify, however, its central flaw explored here: the substitution of individual valuing of resources in place of expectancy. Moreover, critiques that indict economics for its failure to take considerations of equity into account may have the effect of ceding to economics the central component of wealth maximization of contract law. Scrutiny of this aspect of contract law reveals that the economic approach is radically out of step with the efficiency conceived by contract law.\textsuperscript{146}


\textsuperscript{145} For example, Professor Perillo rejects the efficient breach theory and economics as a basis for judging contract, asserting that contract law is “an embodiment of community values,” and only one of those values “happens to be economic efficiency.” See Joseph M. Perillo, Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference, 68 Fordham L. Rev. 1085, 1093 (2000).

\textsuperscript{146} In his article Efficient Breach of Contract: Circles in the Sky, Professor Ian Macneil demonstrates the primacy of counter-measures costs in determining whether a specific performance or expectation creates efficient results. See Ian R. Macneil, Efficient Breach of Contract: Circles in the Sky, 68 Va. L. Rev. 947 (1982). Professor Daniel Farber challenges the assumptions of efficient breach, noting that ignoring transaction costs takes the economic model far afield from the real world. See Daniel A. Farber, Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract, 66 Val. L. Rev. 1443-1448 (1980). Economists might argue that simplifying the real world is justified on the basis that a simplified model can be adjusted to fit the circumstances, including the circumstances of transaction costs. The rebuttal to this point is that the model that assumes circumstances rarely in existence offers little utility and creates problems by changing the starting place of the analysis. Scholars note that the limitations of foresee ability, certainty, and avoidability all work to undercompensate breaching party, making the formula for efficient breach skewed toward breach. See e.g., Daniel A. Farber, Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract, 66 Val. L. Rev. 1443-1448 (1980). Allan Schwartz, The Case for Specific Performance, 89 Yale L.J. 271 (1979). Commentators argue that efficient breach analysis cannot obtain a legitimate result unless all transaction costs are incorporated into the analysis, including pre-contract planning, pre-breach planning, post-breach negotiation. Professor Daniel Friedmann notes that efficient breach increases transaction costs. See Daniel Friedmann, The Efficient Breach Fallacy, 18 J. Legal Stud. 1, 6-7 (1989). Some scholars have suggested changes to contract principles as a counter-balance to the pernicious effects of efficient breach. See e.g., Allan Schwartz, The Case for Specific Performance, 89 Yale L.J. 271 (1979); Richard Schiro, Prospecting for Lost Profits in the Uniform Commercial Code: The Buyer’s Dilemma, 52 S. Cal. L. Rev. 1727 (1979) (advocating reallocation of the foreseeability standard); Patricia H. Marshall, Willfulness: A Crucial Factor in Choosing Remedies for Breach of Contract, 24 Ariz. L. Rev. 733, 761 (1982) (arguing that punitive damages should be allowed when the breach is willful or an unreasonable disregard of the other party). Still others have noted the need for considering equity as a co-equal principle in addition to efficiency. See e.g., Peter Linzer, On the Amorality of Contract Remedies – Efficiency, Equity and the Second Restatement, 81 Colum. L. Rev. 111 (1981); Ian Ayres, Valuing Modern Contract Scholarship, 112 Yale L.J. 881, 891 (2003) (noting equity concerns in addition to the principle of efficiency). Although there will be transaction costs in the real world, for transportation, legal services, locating and negotiating the original and substitute transactions, these costs are generally set aside or assumed away by the hypothetical telling of the story of efficient breach theory. Professor Joseph Perillo provides a summary of these and other persuasive critiques of efficient breach theory. See Joseph M. Perillo, Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference, 68 Fordham L. Rev. 1085 (2000).
Economics articulates economic efficiency by the goal of allocating resources to those who value the resources most. This is not the goal of contract law. The public good conceptualized by contract law is not summarized by the story of efficient breach. Rather than maximizing the value of the resources, contract law seeks to maximize the value of the behavior of contracting. In other words, rather than making the resource contracted for as valuable as it can be, contract law makes contracting as valuable as it can be and, thus encourages the economic activity of contracting, and, consequently, furthers the goal of getting resources into the hands of those who value them most. Efficient breach theory uses the building block of individual valuation as the test for efficient breach. Under the contract regime, by contrast, the interest to be protected is not “valuing” but the allocation made by the parties by contract. Once parties enter a contract, it is the bargain rather than the value of resources that contract law protects.147

In the context of contract law, the two theories are consistent with regard to contract formation. Formation of a contract is a joint act freely undertaken by each party and, accordingly, represents a judgment that the deal furthers the interests of each. It is efficient for both parties. Each theory acknowledges individual valuation of performance as a step in the behavior of contracting.148 This is merely to say that individuals value the performances they bargain for. The theories are not in agreement, however, regarding breach. Considering the different starting places of the two regimes, it is not surprising that they reach different conclusions about effectuating the public good in the context of breach.

The economic view of value expresses well the original event of contracting. Seller “values” a market product in the sense that he prices it at or near what he considers market price. The goods often have no intrinsic value to him. His value relates to the market and to use or resale rather than any inherently subjective value. Nevertheless, the concept of economic valuing comports well with the reality of the transaction. Each party has the power to assent or to reject the deal. Thus, by their actions of entering the contract they express their relative valuing of performance. This sale of goods presents an allocation of resources (both the goods and the money) to parties who value them most without making another party worse off. It is clear that no party is worse off because the sale and purchase represents the free action of each of the actors. Formation presents two rational actors acting in their perceived best interest. Thus, in this happy scenario, Seller, who is a rational actor, will sell the goods to Buyer, another rational actor. The sale is,

147 Contract law does not constrain the subjective evaluation of parties considering breach. It could do so by a no-breach rule. Rather, it constrains breaching party’s ability to recapture the benefit of the bargain from the injured party by the principle of expectancy. Economics are fond of saying that if damages are perfectly compensatory an injured party would be indifferent to breach or performance. This view runs counter to the real world need for performance that courts frequently acknowledge by noting that parties bargain for performance, not for a lawsuit. Despite the imperfections of expectancy damages as they have evolved, however, expectancy damages more nearly seek to make a breaching party gain nothing by breaching (and thus become indifferent to breaching rather than performing).

148 The issue of valuing that figures large in economic analysis is a legitimate issue in the formation stage of contracting.
beyond question, a Pareto Superior event. Each party evaluates his interest and the freely given assent of each is a dependable test of the valuation of each.

Take as the topic breach rather than formation, however, and the economic approach falters and fails to explain doctrine or the social good advanced by contract law. In the situation of breach, only one party to the contract makes a decision. The action of breaching is judged by only one party’s self-interest rather than that of both parties. This decision to breach does not create value. Rather, the breach recaptures the allocation made by the contract and appropriates to one who transferred the value that has already occurred in the market. What appears to be new value, an overall increase in value (and thus an efficient breach), is, in reality, simply a reallocation of market benefit back to the seller. The theory congratulates the breaching party who appropriates to himself the increase in market value despite the fact that this party has transferred his economic right to reallocate the resources allocated by the contract.

Although efficient breach theory does not alter the element of individual choice, it explains the operation of choice in the typical economic sphere of buyers and sellers, assuming that what the breaching party wants in the deal is a greater profit on the transaction at hand. Even accepting this contextualized portrait of economics in the setting of contract breach, the theory fails to produce a realistic portrayal of choice in the market because it fails to take account of the operation of the damage formula of contract law and fails to respect the potential benefit allocated to the original buyer by the contract.

B. Different Circles: Allocation of Contract and Reallocation of Efficiency Theory

The selling point of efficient breach theory is that it benefits society. Like economics, efficient breach theory does not purport to elevate one individual’s interest over the public good. Rather, it offers to further the public good by enhancing the wealth of society based on enhancing the value of resources by reallocating ownership. According to the story of efficient breach, one party to the transaction (of sale, breach and resale) is better off and no one is worse off. Thus, society is benefited by the increased wealth accruing to one advantaged member of society (breaching party). The efficiency of a breach under efficient breach theory is based on the judgment of the party contemplating breach. While proponents of the theory would argue that the objective decision of the court will identify and protect the interest of the injured party, this is not the same thing promised by the theory’s assertion that it compares the subjective value of

\[149\] Of course the party considering breach is free to consider negative effects on the other party. If such considerations predominate and convince that party not to breach, economists would reason that as a rational actor his subjective valuing included empathy.

\[150\] Thus, it endorses rules with the goal of maximizing the wealth of individuals generally although it misconceives the route taken by the law to accomplish this result.
each party better off “(in his own estimation)”\textsuperscript{151} More important, taking damage theory seriously leads to the conclusion that the increase in value the breaching party gains by returning to the market amounts to expropriating on the economic right he transferred to the injured party. In other words, the rights rhetoric employed by economics holding that each party has the right to efficiently allocate his resources is precisely the right transferred by the contract. Taking contract efficiency seriously requires recognition of the full panoply of economic rights, including the ability to alienate the economic right to reallocate resources efficiently.

VI. Conclusion

Contracting is the process of alienating future rights in resources: goods, services, and money. Although the story of efficient breach is set in the context of a sale of goods, the principles it espouses apply to contracts generally\textsuperscript{152} Efficient breach theory presents the view that the wealth of society is enhanced when the value of resources is increased. Contract law, on the other hand, presents the view that the wealth of society increases when the value of contracting is protected. Thus, contract law envisions wealth maximization as a matter of process rather than content or resources. It devises rules that protect the bargain in order to encourage contracting.

Efficient breach theory fails to produce a workable model for explaining contract doctrine or for assessing whether a particular breach is beneficial to society because it supplants the principles of contract law with its own brand of efficiency. Because of its focus on the value of resources rather than the preservation of the deal, efficient breach theory is fundamentally incompatible with the contract concept of efficiency and with the damages regime of contract law\textsuperscript{153} Efficient breach theory enunciates (1) a fact, (2) a legal principle, and (3) a method of analysis that presents a change of attitude about commitment and breach. The fact is that parties have the power to breach contracts. The principle is that contract law compensates the injured party rather than punishing the breaching party. Neither point is new. But efficient breach theory does add something new: a shift in attitude. The theory congratulates the breaching party, asserting that the exercise of the power to breach is a social good. Thus, validating the preference of the

\textsuperscript{151} See Robert Cooter & Thomas Ulen, Law and Economics, \textit{supra} at 12 (2000) (describing a transaction as Pareto efficient “if it is impossible to change it so as to make at least one person better off (in his own estimation) without making another person worse off (again, in his own estimation)”).

\textsuperscript{152} Likewise, the critique presented in this article, though presented in the context of a sale of goods, applies to the theory in the context of the original story and to contracts generally. The contract principle of expectancy damages is not limited to goods transactions; it applies broadly. See Restatement (Second) of Contracts § 347.

\textsuperscript{153} The expression of this point is reminiscent of Grant Gilmore’s assertion that acceptance of reliance as a basis for enforcement heralds the death of contract. Grant Gilmore, \textit{The Death of Contract} (1974). Gilmore’s explanation of reliance theory of enforcement noted the expansion of bases for enforcement of contracts, heralding the re-merging of contract and tort law. By contrast, the issue raised by efficient breach theory relates not to expansion but rather a challenge to the theoretical foundation of the regime of contract law.
changing will, efficient breach theory converts individual preference into a societal good, making breach more likely in the real world and relegating injured party’s interest to damages, an often inadequate remedy.

Identifying the fundamental incompatibility of the two doctrines is important because ignoring the clash of the doctrines puts contracting and commitment at risk. Every theory has normative force for those who accept its norms, and, of course, the norms of society are always evolving. Although one of the virtues of the common law is its ability to change in response to changing social norms, such change should come as a result of informed choice rather than unconscious drift. The danger of efficient breach theory in court is that if courts accept its norms, the theory will eventually aid the breaching party in changing the allocation of the deal, and perhaps by convincing a court that B1’s interest is appropriately described as the price of the original contract or, expected profit, diminishing injured party’s interest and, thus, the force of commitment. Such a limitation is not the outcome of a careful application of the UCC or the common law of damages. Nevertheless, subtle changes in the law come with the economics focus on "value" risking distortion of the law of damages. The danger of efficient breach theory in the market is greater as well. It reduces the preference for contracting and also affects the contracts that parties enter.

The economy of a modern world depends on the ability of parties to plan for the future through contracting. But the attribute of futurity that allows markets to flourish also creates vulnerability to breach. If no time lag occurs between commitment and performance the parties lack the time to reconsider the deal. The lapse of time from

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154 The shifts of meaning and effect that accompany acceptance of the norms of economics are both subtle and dramatic. They include a focus on reevaluation rather than commitment and conversion of certainty of obligation to certainty of damages to facilitate planning. Thus, encouraging more breaches.

155 Economists define the purpose of contract law by conforming it to the efficiency as conceptualized by economics. “The first purpose of contract law is to enable people to convert games with inefficient solutions into games with efficient solutions.” Robert Cooter & Thomas Ulen, Law and Economics at 187 (2000). This analytical move affects the entire analysis, of course. Once contract law is defined in terms of economic principles, economics becomes the yardstick for the law, setting the norms for when contract doctrines succeed or fail. It is easy to take the rabbit out of the hat after you put him in there.

156 Despite the dichotomy detailed in the foregoing analysis, the systems can be harmonized by choosing the dominant principle.

157 Like Tinker Bell, the market is vitalized by people’s belief in it. In Peter Pan the children clap to show Tinker Bell their belief, giving her not only affirmation but life. The invigorating force is belief itself. In contract law this is referred to as the principle of certainty. Credit for this analogy goes to Professor G. Ray Warner.

158 Economists have not attempted to undo a property transfer (as opposed to creation of a contract right) on the basis of efficiency. The power to retake property is so clearly contrary to law that no one has extended the argument of the power dynamic to justify an efficient breach of the property transfer by retaking property. So far at any rate, efficient breach theorists have not sought to validate efficient conversion. The existence of eminent domain rests on public policy justifications rather than on market...
the contract promise to the time of performance means that commitments are vulnerable to reassessment. Will and obligation do not always coexist harmoniously. When they do, contract law is superfluous. If a contracting party's will to perform remains unchanged throughout a transaction (running from the time of commitment to performance) contract law is unnecessary. Only when will and commitment diverge does contract law play a role, protecting the allocation of the contract and trumping the individual will of breaching party to the extent required to secure the benefit of the bargain for the injured party.\textsuperscript{159} In other words, the value of contracting is only important when the other party would not have kept the promise but for contract law. Otherwise, contract law is just a ceremony. Contract law only matters for purposes of commitment when one party would change his mind but for the obligation imposed by the contract. To make parties secure in contracting, the law enforces promises by respecting the allocated benefit of the deal. This vision of efficiency maximizes contracting behavior. A society in which contracts are secure is one in which markets flourish, maximizing wealth by robust exchanges. Thus, individuals in society can reasonably rely on contractual commitments.\textsuperscript{160} The payoff for society is not the enhanced wealth of a particular transaction but, rather, the reliability of commitment and the enhanced wealth that flows from flourishing markets.

Contract law established the efficiency of obligation, the indispensable incentive for a society that wishes to encourage deals for future performance.\textsuperscript{161} While parties to a contract do not obtain a full property interest in the resources contracted for,\textsuperscript{162} they do obtain something of significance: the transfer of the economic right to reallocate resources. Each party allocates to the other this right by the contract. Taking contract efficiency seriously requires recognition of the full panoply of economic rights, including the ability to alienate the economic right to reallocate resources efficiently. This purpose of contract law cannot be harmonized with the basic principle of continuing reallocation of resources, the central principle of economics. Efficient breach allows recapture of the efficiency concepts. See, e.g., Richard A. Epstein, Takings: Private Property and the Power of Eminent Domain, 112 (1985)

\textsuperscript{159} The explanation of binding one’s will is an overstatement except when the market fails to provide a substitute transaction for injured party. The law does not bind the will of breaching party in the ordinary case. Only when damages are inadequate (because of scarcity or uniqueness) does the law regard the contract as binding the will of breaching party by the remedy of specific performance.

\textsuperscript{160} As every law graduate should know, “expectation” is not a synonym for “expected profit.” The term “expectancy” refers to the contract damage principle that enforcement of a contract gives the injured party damages that put him in the place he would have been in had the contract been performed. This measure does not speak to what was “expected” by the injured party at the time of contracting but rather what is necessary based on the flux in the market after the contract to put the injured party where he would have been had he received performance at the time set for performance.


\textsuperscript{162} Courts grant specific performance when damages are not adequate, meaning that the plaintiff cannot get a substitute on the market. Damages are inadequate when goods are unavailable on the market, either because they are unique or so scarce that cover is not available. See UCC 2-716.
right contracted away. Acceptance of efficient breach theory thus necessarily distorts contract law’s central premise of allocation of economic rights and the principle of efficient obligation. Distortion of this principle has profound and subtle effects, destabilizing society’s regard for commitment and disturbing deep moorings of commerce and community.