Chapter 5

The Economics of Contract Law II:
Remedies for Breach

This chapter turns to the question of designing efficient remedies for the breach of enforceable contracts. The basis for the analysis is the "efficient breach model," which specifies those conditions under which it is more efficient to breach a contract than to perform it. The analysis of the various remedies for breach highlights their role in achieving this outcome.

Key Points

- The efficient breach model says that it is efficient to breach a contract when the cost of performance exceeds the value of performance. Monetary compensation is the most common remedy for breach.

- *Expectation damages*, which are equal to the value of performance to the promisee, induce the promisor to breach only when it is efficient to do so. However, they also induce the promisor to overinvest in reliance because they fully insure him or her against breach.

- Limited expectation damages, defined as expectation damages evaluated at the promisee's efficient level of reliance, induce both efficient breach and reliance. This measure of damages corresponds to the remedy established in *Hadley v. Baxendale*.

- The *Hadley v. Baxendale* rule also requires promisees who would incur unusually high damages from a breach to communicate that information up front to promisors. Otherwise, they will not be able to recover those damages in the event of breach.

- The doctrine of *impossibility* discharges performance without damages if performance would have been physically impossible. Because efficient breach is not an issue in this case, the economic theory of impossibility says that this doctrine should be applied so as to assign the risk of breach to the party best able to bear, or insure against, the risk.

- *Commercial impracticability* discharges performance when performance is physically possible but economically burdensome. A proper economic interpretation of this doctrine shows that it functions like a threshold, or negligence, rule to induce efficient breach and reliance in "bilateral care" contract settings.

- *Specific performance* is a court order requiring the promisor to perform the contract as written. According to the Coase Theorem, this will not lead to excessive performance because the promisor can always offer to buy-out the contract if that is the efficient outcome, provided transaction costs are low.

- Compared to money damages, the main advantage of specific performance is that it protects the subjective value of performance for promisees. In so doing, it ensures that excessive breach will not occur.

- Some contracts provide their own remedies for breach (liquidated damages), or failure of the product to perform as advertised (warranties).

- Not all products carry express (explicit) warranties. Courts nevertheless often find an *implied warranty of fitness*, which holds manufacturers liable for damages caused by a defect in the product. Implied warranties represent the intersection of contract and tort (products liability) law.

- Parties engaged in ongoing commercial relationships often employ long-term contracts to save on the costs of re-negotiating each transaction anew. Long-term contracts can also prevent strategic behavior by one or both parties. The merger of trading partners can serve the same purpose. Economic theory says that courts should generally enforce long-term contracts.