EFFICIENT BREACH THEORY THROUGH THE LOOKING GLASS

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

INTRODUCTION

At the center of efficient breach theory is the common law remedy of expectation damages. This remedy requires a party who breaches a contract to pay damages in an amount that would put the aggrieved party in as good a position as the one she would occupy had the breach not occurred. In principle, this gives each party to a contract an incentive to perform when performance is efficient, but not otherwise. The parties, therefore, will complete those contractual projects that are valuable and abandon those that are wasteful, all without potentially costly post-contractual renegotiation. Proponents of efficient breach theory applaud this result and reject any attempt to condemn or punish a party who breaches so long as the victim is compensated, this even if the breach is intentional, by repudiation. Under basic efficient breach theory, no purpose
would be served to induce performance that costs the provider more than such performance benefits the recipient.

Efficient breach theory in its simplest form stops there, however, and though frequently refined, remains substantially incomplete because it neglects a category of cases that forms a conceptual half of efficient breaches. That is, efficient breach theory largely ignores those contracts for which one party’s breach terminates a contract to the benefit, not injury, of the party who does not breach. Doctrinally, a party who breaches cannot sue for damages on the contract and thus cannot collect any benefit conferred by the breach. But one might ask why this should be so. Such suit surely would offend those who would find it immoral for a person to profit from her broken promise. But efficient breach theory is amoral by nature. So the theory fails to explain why the expectation remedy disallows damages for the party in breach. Put another way, those who analyze contract law from an economic perspective frequently note that expectation damages award the benefits of termination to the breaching party; indeed, it is this fact that bestows efficient incentives on a party who contemplates repudiation. When the breach is victimless, however, the surplus does not belong entirely to the party in breach. The question becomes one of why not, or of whether the rule should be otherwise. The answers, it turns out, are not obvious.

Just as property rights analysis until recently overlooked the potential advantages of forced purchases as an alternative to traditional liability rules, contracts analysis has overlooked the potential advantages of an award to the party in breach as part of the expectation remedy,

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such an award, in essence, a put by the promisor of the promisee’s obligation to pay for the promisor’s performance. The objective of this essay is to explore the potential benefits, and costs, of an award to the party in breach and to determine whether a justification for the current law exists within the framework of efficiency theory. In the light of this study, contractually express remedies as alternatives to expectation damages are discussed as is the mitigation doctrine.

Part I elaborates on contract law’s disallowance of an award to the party in breach, also referred to as negative damages, and identifies the prior literature. Part II describes more fully the theory of efficient breach. Part III posits a case in which parties are fully informed about the consequences of contract termination, then relaxes the complete-information assumption and reveals that disallowance of negative damages can yield inefficient breach decisions ex post as well as inefficient investment decisions ex ante; other potential advantages to the allowance of negative damages are discussed as well. Part IV demonstrates that the case for allowance of negative damages is not fully made, however, because such allowance could impose offsetting costs, most prominently from premature breach, costs that might be only partially mitigated by a rule that allowed negative damages only where the party in breach would not otherwise have breached. Part V describes liquidated damages and specific performance clauses as attempts to ameliorate the disallowance of negative damages and discusses impediments to express contractual allowance of negative damages. Part VI examines the mitigation doctrine in light of the law’s prohibition on negative damages. Finally, a conclusion is offered.

I. THE PARADOX OF NEGATIVE DAMAGES

In *United States v. Algernon Blair*, the subcontractor partially performed on a construction contract when the contractor breached and the subcontractor was released from any future obligation under the contract. The subcontractor invoked the doctrine of quantum meruit and claimed $37,000 in restitution for the benefit it conferred on the contractor, which hired a substitute to complete the work that the subcontractor had begun. The trial court did not reach the value of the sub’s restitution claim. Instead it awarded nothing because, the court reasoned, the subcontractor would have lost more than $37,000 had it fully performed. On appeal, the Fourth Circuit reversed and remanded: “For it is an accepted principle of contract law, often applied in the case of construction contracts, that the promisee upon breach has the option to forego any suit on the contract and claim only the reasonable value of his performance.”

Though the case is couched in terms of quantum meruit, it also stands for the proposition that a party in breach of contract cannot sue for damages on the contract. In the opinion, the Fourth Circuit addresses the plight of the contractor, who might have benefited from the bargain that it breached had it performed instead. The court quotes a famous article by Fuller & Purdue: “[I]n suits for restitution there are many cases permitting the plaintiff to recover the value of benefits conferred on the defendant, even though this value exceeds that of the return performance promised by the defendant. In these cases it is no doubt felt that the defendant's breach should work a forfeiture of his right to retain the benefits of an advantageous bargain.”

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2 479 F.2d 638 (4th Cir. 1973).
3 Id. at 640, quoting Susi Contracting Co. v. Zara Contracting Co., 146 F.2d 606, 610 (2nd Cir. 1944).
Consider also the hoary case of *Bush v. Canfield*,\(^5\) where the court encountered a defendant, like that in *Algernon Blair*, who breached his contract and requested a reduction in the plaintiff’s restitution award. The plaintiff was a buyer who had agreed to pay $7 per barrel for flour and gave the seller a $5,000 deposit. At the time and place for delivery, the market price for flour was $5.50. The seller was unable to deliver (or, in any case, did not deliver) and so the buyer sued for the return of the deposit, which the seller resisted on the ground that the failure of delivery enabled the buyer to cover at a lower price. The court ruled against the seller: “[I]t is not for him to say, that if he had fulfilled [the contract], the plaintiffs would have sustained a great loss, and that this ought to be deducted from the money advanced.”\(^6\)

In these cases, the breach may have been inadvertent. The result, though, is not limited to cases in which one party foolishly breaches the contract. A defendant might breach because performance has become prohibitively costly, yet try to defend against a restitution claim on the ground that the nonbreaching party would not have benefited from performance either. The doctrine plainly disallows this defense as well.

The cases do not directly address a breaching party’s affirmative claim to damages in the amount that the breach saved the nonbreaching party. But it goes almost without saying that such a suit would fare no better than a defense against a restitution claim. The lack of case law directly on point may merely be testament to the fact that parties in breach are not brazen enough even to suggest affirmative recovery.

The doctrine seems straightforward, then. A party who breaches a contract breaks a promise and is in the wrong. She deserves no benefit from that contract. Some would defend this

\(^{5}\) 2 Conn. 485 (1818).
\(^{6}\) Id.
position. Charles Fried, for example: “There is a convention that defines the practice of promising and its entailments. This convention provides a way that a person may create expectations in others. By virtue of the basic Kantian principles of trust and respect, it is wrong to invoke that convention in order to make a promise and then to break it.”

This philosophy notwithstanding, however, it is accepted wisdom that Anglo-American contract law takes an amoral approach to promises. More than a hundred years ago, Oliver Wendell Holmes said this: “The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, and nothing else.” Holmes’s statement has become the basis for an approach to contract law where the party in breach is not a wrongdoer. Such a party does not break a promise, but rather exercises an option to fulfill one promise over another: the payment of damages, if any, rather than performance of the activity specified. As expressed by Justice Scalia: “Virtually every contract operates, not as a guarantee of particular future conduct, but as an assumption of liability in the event of nonperformance.” Or, in the words of Judge Posner: “In Holmes’s vivid formulation, the obligation created by a contract is an obligation to perform or pay damages for nonperformance, and if the second alternative remains, then, since it is an alternative, the obligation created by the contract is not impaired.

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9 Whether Holmes meant to suggest this is a matter of debate. See Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 Fordham L. Rev. 1085 (2000). But neither Holmes’ intent nor any inconsistency in the law’s adherence to the principle is relevant to this article. Rather, the Holmes quote, as it has been interpreted, reflects a school of thought that has not heretofore addressed the paradox of negative damages.


11 Horwitz-Matthews v. Chicago, 78 F.3d 1248 (7th Cir. 1996).
The question arises, then, if a party in breach is not a wrongdoer, why is it that she cannot collect from a nonbreaching party who is a beneficiary rather than a victim of the breach. To be sure, there is a clear distinction between paying and collecting, and thus a damages floor of zero may seem salient. But it is not immediately clear what justifies such a floor. If the party in breach has not misbehaved, one wonders why she should not collect, particularly because collection can leave the party not in breach with the full benefit of his bargain. Consider, for example, a simplified version of Bush, where the seller breaches a contract for the sale of a single barrel of flour at a price of $7 and the buyer covers for $5. The buyer could pay the seller $2 and still receive her due, a barrel of flour for a total cost of $7. Contract doctrine says the $2 difference stays with the buyer, but it isn’t apparent why.

The Holmesian rejection of fault as a basis for contract remedy has lead to a focus on economic efficiency as a basis for a damages award. Parties to a contract are treated as venturers in a joint enterprise and remedy is addressed not as a tool for corrective justice but rather as a means to maximize the parties’ joint welfare. Thus, economic analysis is a natural approach to the question of whether the law should provide for negative damages.

Yet, the prior literature on the economics of negative damages is sparse and arises in a desultory set of narrow contexts: In the examination of the impossibility or impracticability doctrine, Alan Sykes and Michelle White, independently, have observed that negative damages might be an appropriate response to promisor risk aversion;¹² in the analysis of a signaling model, Hermalin & Katz described a potential role for negative damages where one party is un-

aware of the other’s type;\textsuperscript{13} as part of a mechanism design, Edlin has noted that negative damages would undermine an attempt to assign one party the breach decision;\textsuperscript{14} in the analysis of cover and bankruptcy ipso-facto clauses, respectively, Jackson and Che & Schwartz have observed that where prices may fluctuate between breach and performance, or where a court must estimate damages, an expected award is skewed by the truncation at zero of the damages distribution;\textsuperscript{15} in a discussion of restitution, Cohen has defended the prohibition on negative damages as a means to dampen strategic behavior by a party who seeks to avoid the uncompensated transactions cost of performance;\textsuperscript{16} as part of a discussion on promisee insecurity, Craswell and Geotz & Scott, independently, have considered whether a party may terminate a contract based on her counterparty’s perceived inability to perform;\textsuperscript{17} in the context of the mitigation doctrine, MacIntosh & Frydenlund noted a connection between the disallowance of negative damages and the parties’ breach decision, described below, but did not offer a substantial analysis of how negative damages might affect economic efficiency.\textsuperscript{18} A goal of this essay is to provide a general analysis that fills the gap in the literature.


\textsuperscript{14} See Aaron S. Edlin, Cadillac Contracts and Up-Front Payments: Efficient Investment under Expectation Damages, 12 J.L. Econ. & Org. 98 (1996).


II. Efficient Breach Theory

A cornerstone of the economic analysis of contract law is the theory of efficient breach. This theory begins with the observation that the expectation damages remedy for breach requires a promisor to provide the promisee the full benefit of her bargain, but no more. So, if a contractor agrees to paint a house for $10,000 and then reneges, the contractor must pay the homeowner the difference between the value of the work to the homeowner and $10,000. Suppose that the value of a paint job to the homeowner exceeds $14,000, which is the amount the contractor’s competitor would charge to do comparable work. The contractor would thus owe the homeowner $4,000.19 With that amount, and the $10,000 the homeowner had been bound to pay the contractor, the homeowner can hire the competitor and get what she expected from the initial contract, a painted house in exchange for (net) $10,000.

Consider the contractor’s incentives given the expectation remedy. If, at the time of performance, the contractor’s cost exceeds $14,000 she will breach, through repudiation, and pay damages. If, at that time, her costs are less than $14,000 she will perform, despite any loss on the contract, a loss she would incur if her costs exceed the $10,000 contract price. Because $14,000 is also the social value of performance, determined in this case by the cost of the competitor’s work,20 the contractor’s private incentive also assures an optimal performance or breach decision: perform when it is efficient to do so, breach otherwise. Thus, expectation damages can usefully induce the parties to behave in a mutually beneficial fashion even where they cannot fully

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19 This calculation implicitly incorporates the promisee’s duty to mitigate, discussed in part VI, below.
20 For simplicity, assume that the market for a painter’s services is competitive and that the price of substitute performance also reflects its social value.
specify such behavior, an observation first made by Shavell.21 In this illustration, the parties might have specified that the contractor would be obligated to perform if and only if her realized costs were less than the market rate for the work, here $14,000; they then could have separately allocated the risk of a cost increase that would excuse performance and could have adjusted the contract price accordingly.22 But it is not always useful to specify the contractor’s costs as a basis for obligation as these costs may be difficult to observe or to verify in a court.23 The genius of the expectation damages remedy is that it allows self interest to guide the parties toward an efficient decision based even on unobservable factors (so long as there are sufficient observable or easily determined ones, here the competitor’s price and the homeowner’s willingness to pay that price).24

There is, in addition, an ex ante aspect to efficient breach theory. Suppose that the damages for the contractor’s breach in the above illustration were set at a punitive level, say $10,000, while the contractor’s cost of performance is $18,000. In this case, the contractor might perform and suffer an $8,000 loss rather than pay the higher damages. (The penalty would thus be the


22 Relative risk aversion would determine how the parties would allocate risk, but the affects of risk aversion are beyond the scope of this essay.

23 A recent literature has developed on how parties might shape their contractual obligations given the difficulty of verification. See, e.g., Albert H. Choi and George G. Triantis, Completing Contracts in the Shadow of Costly Verification (working paper, 2007), arguing, among other things that parties sometimes intentionally include difficult-to-verify terms and incur the potential for costly litigation as a signal or in order to enhance the promisor’s performance incentives. Such analysis is beyond the scope of this essay. Sufﬁce it to say here that parties will not always prefer diﬂicult-to-verify terms. Compare Barry E. Adler, Avarice-Based Forfeiture (unpublished manuscript, 2007), arguing that difficult-to-verify terms may yield costly pooling of heterogeneous party types.

24 Not all would agree that expectation damages are genius. Robert Scott and George Triantis, for example, have argued that in thin-market settings parties should be encouraged to contract around expectation damages, to achieve efficient risk allocations, for example. See Robert E. Scott and George G. Triantis, Embedded Options and the Case Against Compensation in Contract Law. For reasons given in the text, though, many parties would expressly contract for expectation damages even if they were not the default. The matter is not discussed further here.
equivalent of an order of specific performance, another alternative to expectation damages.) But the parties might renegotiate instead and would settle on an amount between $4,000 and $8,000 that the contractor would pay the homeowner for a release. (Assume that while the contractor’s competitor would do comparable work, the work would not be identical and the contractor, therefore, could not unilaterally substitute the competitor’s performance for its own.)

The cost of such negotiations, unnecessary under expectation damages, would count against a damages rule that awarded a penalty, but if renegotiation costs were low, this might not be important. Negotiation costs, aside, however, the penalty could be inferior to expectation damages once one considers the contractor’s incentive to invest in precaution against breach.

Imagine that the contractor’s expected cost at the time of performance is a stochastic variable, the distribution of which the contractor can affect in advance with an investment, in the employment of a skilled manager, for example. The contractor’s private incentive to so invest depends in part on the damages it would be forced to pay should a high-cost realization make performance inefficient. The socially optimal investment is one that reflects a $4,000 damages award, the true cost of breach, and if the contractor instead anticipated a payment of between $4,000 and $8,000 it will overinvest. Similarly, if the anticipated award were an amount below true cost, the contractor would underinvest in precaution compared to the social optimum. These costs of deviation from the expectation remedy would be borne by the parties jointly, however a

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25 Where there is a thick market for performance, the distinction among a penalty, specific performance, and expectation damages fade as a promisor can on her own substitute a competitor’s performance and not breach the contract at all. See Alan Schwartz, The Case for Specific Performance, 89 Yale L.J. 275 (1979). Compare note 41.

26 But see Craswell, cited in note 17, which observes that where information about the cost and benefit of performance is asymmetric, the parties would have reason to negotiate even under an expectation remedy.
price adjustment allocates the loss and whether or not renegotiation yields an efficient breach decision ex post.

This is not to say that expectation damages yields ideal results. They do not. Where parties invest in a contractual project, as did the contractor in the above illustration, expectation damages yields too much investment. This is because each party treats the performance of the other as certain and invests in its own end of the project as if it will fully benefit from the other’s performance, as the other will either perform or pay for its failure to do so.\(^{27}\) The socially optimal investment, by contrast, would cause each party to discount its own investment based on the possibility that the project might efficiently be abandoned. The parties may contractually predetermine (or “liquidate”) moderate damages in order to separate the breach remedy from actual investment, and thus cure the overinvestment incentive, but liquidated damages can create their own inefficiencies, such as perverse incentives to breach ex post when the realized costs and benefits of performance differ from expectations at the time of contract. Theories on the overinvestment incentive of expectation damages, the stochastic nature of cost, and the role of liquidated damages have usefully been pioneered and refined by Shavell,\(^{28}\) Craswell,\(^{29}\) Cooter,\(^{30}\) and Goetz & Scott,\(^{31}\) among others. Theoretical qualifications and refinements aside,\(^{32}\) however, ex-

\(^{27}\) If there is a risk of promisor insolvency, this will not hold. See Steven Shavell, The Judgment Proof Problem, 6 Internat’l. Rev. L. & Econ. 45 (1986); see also Craswell, cited in note 17. This complication is ignored here for simplicity.

\(^{28}\) See, e.g., Shavell, cited in note 21.


\(^{32}\) Not all qualifications suggest that the expectation remedy tends toward excessive awards. The Triantis brothers argue that expectation damages ignore the promisee’s option to breach and thus yield undercompensatory damages and premature repudiation. See Alexander J. Triantis and George G. Triantis, Timing Problems in Contract
pectation damages are both the doctrinal norm and a tolerably proficient mechanism for the encouragement of efficient investment and breach decisions.33

III. THE VIRTUES OF NEGATIVE DAMAGES

As may be apparent from the theory of efficient breach, expectation damages can induce the correct breach decisions because they permit the party in breach to capture the entire surplus from termination of the contractual project. In the above illustration, for example, it would cost the contractor $18,000 to perform while it would cost its competitor only $14,000. The value of performance to the homeowner exceeded this amount. The contract price was $10,000 and the damages the contractor owed the homeowner for breach was $4,000. The social surplus from breach, therefore, was $4,000, which is also the amount the contractor saved when it breached and paid damages rather than perform. Expectation damages thus aligned the contractor’s incentives with that of society and at the same time honored the homeowner’s bargain. As a result, expectation damages yielded breach as a Pareto superior alternative to performance. This is a general result.

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Breach Decisions, 41 J.L. & Econ. 163 (1998). This result, however, depends in part on implicit and strong assumptions about the nature of current prices and the estimation of cost. Compare Barry E. Adler, The Nature of Price and Cost as Determinants of Breach (unpublished manuscript, 2007). Moreover, not all theoretical refinements are limited to those mentioned in the text. For example, Edlin and Reichelstein show that where renegotiation costs are low and where one party’s investment does not affect the return of the other specific performance can achieve nearly ideal results. See Aaron S. Edlin and Stefan Reichelstein, Holdups, Standard Breach Remedies, and Optimal Investment, 86. Amer. Econ. Rev. 478 (1996). These qualifications and refinements are beyond the scope of this essay.

33 This is particularly so given that the law curbs the excesses of expectation damages with a variety of doctrines, including those that disallow unforeseeable and speculative damages. See, e.g., Hadley v. Baxendale, 156 Eng. Rep. 145 (1854) (disallows unforeseeable damages); Chicago Coliseum Club v. Dempsey, 265 Ill. App. 542 (1932) (disallows speculative damages). See generally, Cohen, cited in note 16. But see Brooks, cited in note 1, who observes that efficiency may be served as well with a damages remedy permitted an award in excess of expectation damages provided that certain safeguards are in place, such as due compensation for the promisor’s efficient reliance.
Disallowance of negative damages breaks the connection between the promisor’s private incentive and social welfare. This has been largely overlooked, perhaps because simple analysis assumes symmetric, complete information. Consider the following illustrations, based loosely on Algernon Blair. In an initial set of illustrations, the promisor has private information that performance is inefficient, or a unique opportunity to discover this fact, but would benefit from performance nonetheless. That negative damages can promote efficiency in this setting is the central insight of this part, but not the only relevant observation. Thus, in a subsequent illustration, judicial estimation leads to overcompensation for the promisee in the event of breach, a result that negative damages would counter. And in a final illustration, a promisor, turned promisee, engages in strategic litigation over the question of whether there has been a breach and by whom, again an outcome that negative damages would counter.

A. Promisor Private Information

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

Matters change when one relaxes the assumption of symmetric, complete information. An efficient breach decision subject to expectation damages requires that a promisor know not only her own cost but also the promisee’s benefit. Thus, as is commonly known, a party’s ignorance of her counterparty’s benefit can yield an inefficient breach decision. Not well understood is that the disallowance of negative damages exacerbates this problem where only one party knows that breach is efficient and that party will nevertheless benefit from the contract.35 Significantly, inefficient performance may occur even in the plausible and stubborn circumstance that a party’s private information is limited to its own cost, with information about the other party’s benefit symmetric and complete.36

Another version of the contractor illustration may clarify. A contractor agrees to construct a landowner’s building over a period of time in exchange for $20 million. As time passes and work begins, there is a substantial influx of construction inputs and the general market for contractor services shifts so that the landowner could now obtain comparable substitute performance for $15 million, but would also suffer a $2 million dislocation cost from delay that would result in the switch as a new contractor could not redeploy immediately and would have to learn the job specifications. The increase in supply for construction inputs corresponds with a general

34 In a richer illustration the decision to terminate would depend on the variance in costs and benefits as well as the cost of deferring the termination decision, none of which is described here, or needs to be given the purposes of the illustration.
35 A (slightly) more formal presentation of this central result for this essay is provided in the Appendix, which gives an algebraic account of the illustrations that follow in the text.
36 MacIntosh & Fryerlund, cited in note 15, note the potential for information asymmetry to yield inefficient breach decisions under expectation damages, but they treat the problem as largely insoluble unless one party has superior information about the other party’s affairs, an unexplained assertion disputed here, in this part.
recession and the value of the building project to the landowner has declined to $16 million. In addition to these commonly known circumstances, unbeknownst to the landowner, the contractor has suffered an internal management crisis that has increased its cost of production relative to that of its competitors. Consequently, it would cost the contractor $18 million to complete the project.

In this illustration, termination is efficient because it would cost the contractor $18 million to provide a building worth $16 million and, given the expense of dislocation, if the contractor were replaced, the total cost of construction would be $17 million; the project should be abandoned. Yet, under expectation damages and the disallowance of negative damages, it may be that neither party will terminate. The contractor will not repudiate unilaterally because, while it would pay no damages, neither would it collect any. The alternative for the contractor is to perform and earn a $2 million profit. If the landowner believes that the contractor is typical—and by hypothesis it has no reason to assume otherwise—then the landowner will not repudiate, as if it did it would expect to pay damages of $5 million. The alternative is to pay the $20 million contract price for a building worth $16 million and lose $4 million. Were negative damages allowed, however, the contractor would repudiate the contract and collect $4 million from the landowner, the difference between the contract price and the value of performance, an amount that reflects the contractor’s $2 million expected profit at the time of repudiation and the $2 mil-
lion surplus from contract termination. In essence, the allowance of negative damages would harness the promisor’s private information,\(^3\) and the disallowance of negative damages is thus shown to do harm.

Despite the foregoing, the parties might negotiate for efficient termination even where negative damages are disallowed. The landowner could, for example, attempt to induce termination with a blind offer to pay the contractor for cancellation of the contract on the chance that performance is inefficient. In this illustration, there is a range for agreement between $2 million and $4 million. But without information about the contractor’s true costs, the landowner’s offer could be out of range or appear, or be, aggressively low, and might lead to bargaining expense or breakdown as the contractor might require, or simply hold out for, a greater amount.\(^4\) In this setting, moreover, information asymmetry could be difficult to overcome. The contractor would not readily reveal its true cost because, armed with information of what would be a sufficient offer, the landowner would not negotiate, but rather would exploit such information through immediate repudiation, and a payment to the contractor of only $2 million.

Variants of this illustration yield similar observations. A contractor agrees to construct a landowner’s building over a period of time in exchange for $20 million. As time passes and work begins, there is a substantial influx of construction inputs and the general market for contractor services shifts so that the landowner could now obtain comparable substitute performance for

\(^3\) Compare Ayres, cited in note 1 at 96, which contemplates a form of truncated auction, where a promisee can through an offer of supplemental payment for performance increase the damages paid by a promisor in the event of the promisor’s breach (thus not negative damages), and observes that such an auction can harness a promisee’s private information, where such information exists.

\(^4\) It is well established that bilateral monopoly negotiation can be costly where information is asymmetric. See, e.g., Robert Gibbons, *Game Theory for Applied Economists* 218 (Princeton University Press, 1992).
$15 million. In this version of the illustration, the building project remains valuable to the landowner, so if the contractor and landowner terminated their relationship, the landowner would replace the contractor with a competitor at the going rate for the work, but would also suffer a $1 million dislocation cost from delay that would result in the switch. If the contractor unilaterally abandoned the project but tendered the work of a competitor, imposition of the dislocation cost would constitute a breach of the contract. Unbeknownst to the landowner, as before, the contractor has suffered an internal management crisis that has increased its cost of production relative to that of its competitors. Consequently, it would cost the contractor $18 million to complete the project.

In this illustration, as in the last, termination is efficient, here because a competitor can construct the building for $3 million less than it would cost the contractor at a dislocation cost of only $1 million. Yet, under expectation damages and the disallowance of negative damages, it may be that neither party will terminate. The contractor will not repudiate unilaterally because, while it would pay no damages, neither would it collect any, as before. The alternative for the contractor, again, is to perform and earn a $2 million profit. If the landowner assumes that the contractor is typical—and again, by hypothesis, it has no reason to assume otherwise—then the landowner will not repudiate, as if it did it would expect to pay damages of $5 million and suffer

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41 This is a pivotal assumption in this version of the illustration, one suggested previously in note 25. If the contractor could itself hire a competitor to do the work and keep the landowner bound to perform in return, the problem addressed by this illustration would vanish. The assumption is not strong, however, at least not universally so. As discussed more fully below in part III(c), a breach such as the imposition of a dislocation expense in this illustration—perhaps for failure to meet a progress schedule—may be considered material and thus release a promisee from its contractual obligations. See Restatement (Second) of Contracts §241 (1979). Moreover, it is sometimes the case that the mere identity of a substitute performer will constitute a breach if attempted unilaterally by the promisor, as in the case of a personal services contract or a government procurement contract, among others, even where the promisor is a corporate entity. See, e.g., 41 U.S.C. §15 (government contracts); Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1997) (patent license).

42 But see note 34.
the $1 million dislocation cost, each in addition to the $15 million for the cost of completion by another contractor, for a total cost of $21 million.\footnote{But see note 38.} The alternative is to pay the $20 million contract price. Were negative damages allowed, however, the contractor would repudiate the contract and collect $4 million from the landowner, which again reflects the contractor’s $2 million expected profit at the time of repudiation and the $2 million surplus from contract termination. The disallowance of negative damages again causes harm. Again the parties might renegotiate, but just as in the prior illustration, renegotiation would be plagued by information asymmetry as the contractor would not reveal its alternative opportunity or the landowner would exploit such information through immediate repudiation, and a payment to the contractor of only $2 million.\footnote{The parties might have contracted ex ante so that the contractor could unilaterally substitute performance of a competitor despite what the default rule would consider a material breach. However, the parties would not be confident ex ante that this provision would be invoked only where it would be efficient. See note 41.}

A further modification of the illustration reveals that there is a potential for the disallowance of negative damages to create another sort of inefficiency, one in ex ante search incentives. Assume, as before, that a contractor agrees to construct a landowner’s building over a period of time in exchange for $20 million. Again, as time passes and work begins, there is a substantial influx of construction inputs and the general market for contractor services shifts, so that the landowner could now obtain comparable services for $15 million. As before, the building project remains valuable to the landowner, so if the contractor and landowner terminated their relationship, the landowner would replace the contractor with a competitor at the going rate for the work, but would also suffer a $1 million dislocation cost from delay that would result. Now, however, assume that although the contractor would benefit like its competitors from the influx of construction inputs, unbeknown to the landowner, the contractor has a unique opportunity to
pursue an alternative construction project, one for which it may be uniquely suited, and one that if won would pay it $18 million at the same cost as the contractual project with the landowner; the contractor lacks the capacity to complete both the new project and the contractual project. It would be costly for the contractor to pursue the new project; the more it invests in this pursuit, in what I will call search, the greater the likelihood it will win the new project.

This illustration matches the prior one with the exception that the contractor’s cost of performance now includes a stochastic opportunity cost with a value that is a function of investment in search. It becomes quickly apparent that the contractor will underinvest in search. To see this, assume provisionally that ex post renegotiation on the contract is prohibitively costly. In this case, neither party will repudiate the contract even if the alternative opportunity materializes. As before, the landowner would expect to pay $21 million if it repudiated and would prefer to pay the $20 million contract price instead. Also as before, the contractor will not repudiate if negative damages are disallowed. If the contractor performs on the contract it will earn a $5 million profit; this amount is the contract price less the contractor’s costs, which here are common with its competitors. If the contractor breached instead it would neither pay nor collect damages, as before, but would earn only $3 million in profit from the alternative job. Performance, thus, would be certain even though society would benefit by $2 million if the contractor repudiated and took the alternative work; this amount is the difference between the $3 million in value forgone when the contractor declines the alternative project for which it is uniquely suited less the $1 million in dislocation costs saved by such action. Were negative damages permitted, the contractor would repudiate, collect $4 million from the landowner and earn $3 million on the alternative project, a total that reflects its $5 million expected profit on the contract and the $2 mil-
lion termination surplus. But, as just demonstrated, if negative damages are disallowed, where renegotiation is impossible, this surplus will be forgone in all cases and the contractor will invest *nothing* in search.

Matters improve if renegotiation is possible. But the contractor’s underinvestment in search will persist here even if the parties could without transaction cost renegotiate for an efficient outcome ex post should the opportunity materialize. This is so because even if the contractor could be counted on to negotiate rather than repudiate upon knowledge of the contractor’s realized alternative opportunity, the parties can be expected to divide the social surplus from such opportunity. Consequently, ex ante, the contractor will not expect to gain $2 million if the opportunity arises, but some fraction of that amount. Because it bears the full cost of search, though, it will invest less than is socially optimal.46 Again, the disallowance of negative damages is shown to be costly, here perhaps counterintuitively, because a promisor might not seek to *increase* its cost of performance where it alone has an opportunity to do so.47

**B. Judicial Estimation of Damages**

There are, as well, other sources of inefficiency that stem from the disallowance of negative damages. Consider another version of the construction contractor illustration, a version in which the contractor anticipates that value of its performance to the landowner lies within a range that also includes the contract price. It is assumed that a court is unable precisely to esti-

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45 Compare note 43.
46 This is a standard result. See, e.g., Alan Schwartz and Robert E. Scott Precontractual Liability and Preliminary Agreements, 120 Harv. L. Rev. 661 (2007).
47 As a conceptual matter, the disallowance of negative damages could remain and expectation damages could be modified merely to permit compensation for reasonable investment in creation of the opportunity for efficient breach. Compare, Brooks, cited in note 1, which argues that a victim of breach might efficiently be entitled to disgorgement remedy reduced by the promisor’s reasonable expenditures. As described above in part II, however, the usefulness of expectation damages is premised on the observation that efficient investment is difficult to verify.
mate this value. Given such uncertainty, because the disallowance of negative damages truncates at zero the distribution of a damages award, the contractor’s expected liability from repudiation is inflated above an unbiased estimate of the landowner’s loss from termination. Rather than breach and pay this inflated expected amount, or bear the cost of a negotiated termination, the contractor might perform even if termination were efficient.

Specifically, assume that the contractor has agreed to construct a building for the landowner in exchange for $20 million. At the time the contractor must decide whether to perform, the cost of performance is $21 million while the benefit to the landowner is negligibly above the contract price. Termination is thus efficient. Assume, though, that a court would need to estimate the benefit of performance. Imagine that the court will determine damages with a draw from a benefit distribution that includes the true value, $20 million, which has a 50% likelihood of selection, a low estimate of $15 million, which has a 25% likelihood, and a high estimate of $25 million, which has a 25% likelihood. Where negative damages are disallowed, the contractor’s expected liability for breach will be .25($5 million) or $1.25 million when the actual damages are approximately zero. As a result, even if risk neutral the contractor has an incentive to perform and lose $1 million, which here is also society’s loss.48 Were negative damages permitted, by contrast, the possibility of an approximately $5 million positive liability would be offset by an

48 This is illustration is stylized and ignores the variance in costs, as opposed to their estimation, between the time of repudiation and the time of performance. Triantis & Triantis, cited in note 32, observes that cost variance may yield an offsetting tendency for undercompensation given current judicial implementation of the expectation remedy, which, according to Triantis & Triantis, fails to account for the promisee’s own breach option. But even if this is so, the law could, in principle, correct both biases rather than allow them to compete as they will not always perfectly offset one another. See also note 43.
equally likely possibility of an approximately $5 million negative liability, and the proper incentives would be restored.\textsuperscript{49}

These ex post effects of a damages distribution truncated at zero have been observed elsewhere, by Jackson and by Che & Shwartz, for example, albeit in narrower contexts.\textsuperscript{50} It is important to stress the ex ante consequences as well. Anticipation of an excessive damages award can lead a promisor to overinvest in precaution. For example, in this illustration, the contractor might invest in preparation for the project, ordering and storing materials in advance, for example, to reduce its expected cost of completion at the time of performance. How much the contractor would so invest would depend on the consequences of a high realization. Here the value of the project, ex post, was little more than the contract price and one might imagine that even at the time of contract the expected value of the project did not greatly exceed the expected cost. The contractor’s optimal investment in precaution would be correspondingly small, but the contractor will overinvest where it anticipates that breach would cost it up to $1 million—plus perhaps the cost of negotiation in an attempt to settle on a lower amount\textsuperscript{51}—even if the landowner is not injured.\textsuperscript{52} This phenomenon exacerbates the well known overinvestment incentive generated by the fact that expectation damages reflect actual rather than optimal investment by the parties.\textsuperscript{53}

\textsuperscript{49} This conclusion is a simplification. As discussed above in part II and below in part IV expectation damages creates a general tendency to overinvest in reliance and in precaution. Negative damages may generally exacerbate this problem, as discussed below, but with respect to overinvestment generated by judicial estimation the effect is palliative.

\textsuperscript{50} See the sources cited in note 15.

\textsuperscript{51} Compare note 40 and related text.

\textsuperscript{52} The text generalizes the result in Che & Schwartz, cited in note 15, which observes that the truncation of damages at zero induces the promisor to invest too little in the avoidance of insolvency.

\textsuperscript{53} See notes 28-31 and related text.
There is more. Some breach is stochastic (an accident) rather than deterministic (by repudiation). Thus, one could plausibly consider an alternative model for the effect of precaution, one where precaution reduces the probability of breach. Still, the disallowance of negative damages induces promisor overinvestment because the expected damages award would exceed actual damages. In this illustration, breach would in fact cost the landowner almost nothing, but the contractor would expect to pay damages of $1.25 million. The allowance of negative damages would restore proper incentives in this case as well.

C. Uncertain Breach

The foregoing has implicitly assumed that a breach, if one occurs, is a total, singular event and that the identity of the breaching party is certain. Neither is true in fact. Consider a case in which a promisor fails to satisfy an early part of its contractual obligation, or otherwise gives an indication of a pending breach, all while the promisor suffers financial difficulty that causes the promisee to fear that the promisor will be unable either to perform fully or pay damages for this failure. As Craswell has observed, in a situation such as this, the promisee may have a better incentive to make a termination decision than the promisor. This is so because a premise of efficient breach theory is that a promisor internalizes the cost of a repudiation decision. An insolvent promisor will not do this and so if the promisee has information that allows it to make the proper decision, the law should provide it with the incentive to do so; otherwise, the promisor might gamble—in essence, with the promisee’s money—by continuing a project that should be

54 See, e.g., Craswell cited in note 29; Cooter cited in note 30.
55 See note 49.
56 See Craswell, cited in note 17; Compare Goetz & Scott, id.
terminated.\textsuperscript{57} The law, to some extent provides this result through the related doctrines of material breach and adequate assurance of future performance.\textsuperscript{58} If the promisor has materially breached a contract, or (at least under the Uniform Commercial Code) if the promisee otherwise has reason to be insecure about future performance, the promisee may terminate the contract and collect damages from the promisor. The promisee thus has a relatively robust incentive to terminate when it is efficient to do so.

The damages that a promisee can collect in this setting are not negative damages in the sense used here. This is because, while the promisee can collect (to the extent of the promisor’s solvency) its own lost profits from termination of the project, it cannot collect any savings bestowed on the promisor from the termination. Thus, although the doctrines of material breach and adequate assurance permit a party to make a termination decision yet collect damages, a better characterization of the result than an award of negative damages is an expansion of how the law defines promisor breach. Regardless of the terminology applied, these doctrines represent an attempt by the law to harness information that might be wasted unless the informed party has the incentive to act. As discussed earlier in this part, a more general permissibility of negative damages would also have this effect, but more broadly, and in the perhaps more common circumstance that the useful information is about the party’s own affairs. There is, moreover, a more direct connection between the doctrines of material breach and adequate assurance on the one hand, and a proposal for more liberal allowance of negative damages, on the other. The latter may reduce unintended consequences of the former. Again, an illustration may clarify.

\textsuperscript{57} See Craswell, id.

\textsuperscript{58} See Restatement (Second) of Contracts §241, also cited in note 41; UCC §2-609. For related doctrines, see UCC §§2-508; 2-612.
Consider the following. A contractor agrees to construct a landowner’s building over a period of time in exchange for $20 million. As the project progresses, the contractor recognizes that its cost of completion will be $22 million, an amount that is $2 million less than any competitor would charge to finish the project. Completion of the project is worth $25 million to the landowner. Thus, performance is efficient, but the contractor would prefer to be relieved from its contractual obligation. A term of the contract requires that the landowner continually drain the building site so that there is no standing water during construction. The landowner drains the site periodically, but some water remains. A dispute arises as to whether the water that cannot be removed is significant.

The contractor claims that the landowner has materially breached the agreement and seeks termination. The landowner argues that the breach is minor and can be remedied by a trivial increase in the price paid for construction. If the breach is minor, or even if it is not but the landowner will reliably pay any damages from its continuing failure to remove water, the contractor should remain bound. But these determinations are difficult. The line between immaterial and material breach is not bright, and courts struggle over the distinction. Thus, a court might rule in favor of the contractor even if the landowner’s breach is insubstantial and the contractor’s grievance entirely strategic. As Goetz & Scott warned, the result could be termination of an efficient project or costly negotiation to prevent this outcome.59 Moreover, even if the project is not terminated and renegotiation is costless, renegotiation would force the landowner to sacrifice some portion of its expected return from the contractual project. That is, in renegotiation, the

59 See Goetz & Scott, cited in note 17. See also Craswell, id. For similar analysis in related contexts, see George L. Priest, Breadth and Remedy for the Tender of Nonconforming Goods under the Uniform Commercial Code: An Economic Analysis, 91 Harv. L. Rev. 960 (1978); Alan Schwartz, Cure and Revocation for Quality Defects: The Utility of Bargains, 16 B. C. L. Rev. 543 (1975).
landowner would expect to pay the contractor between $22 million and $24 million to complete the project when the contract price was only $20 million. Ex ante, anticipation of such ex post renegotiation, which will occur with a positive probability, reduces the landowner’s incentive to invest in reliance on the contractor’s performance and increases the landowner’s incentive wastefully to take precaution against trivial breaches, which can have nontrivial consequences.

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

The use of negative damages to combat strategic behavior in this setting may be too fine grained to be useful. As noted above in part II, and discussed further immediately below, the ex-

60 See Craswell, cited in note 17 at 419.
61 Prohibitions on renegotiation are often theoretically desirable but may prove difficult to enforce in practice. See, e.g., Alan Schwartz and Joel Watson, The Law and Economics of Costly Contracting, 20 J. L. Econ. & Org. 2 (2000).
pectation remedy induces overinvestment in reliance. So it is conceivable that the risk of strategic termination is a useful mitigation of that incentive, one that balances the incentive for wasteful precaution induced by such risk. Suffice it to say, though, that there are a number of potential advantages to the allowance of negative damages, advantages that the law and commentators have largely overlooked perhaps because the concept itself seems absurd. The analysis in this part is designed to dispel that impression and to prompt greater attention to the issue.

IV. THE VICES OF NEGATIVE DAMAGES

The analysis above shows that the allowance of negative damages would have virtues. The case for allowance of negative damages is not made, however. Such allowance could impose offsetting costs in the forms of perverse investment incentives and premature repudiation of contractual projects.

An initial point in this regard is that where the promisor can affect the promisee’s value of the promisor’s performance, or the cost of the promisee’s performance, the promisor may succumb to a perverse incentive. That is, the promisor may expend resources in an attempt to lower the value of the contract to the promisee then breach and collect the fruits of its wasteful efforts. A promisor may seldom have such an opportunity, though, and so this cost of negative damages might not generally be a problem.

More broadly applicable, the allowance of negative damages may exacerbate the general tendency of expectation damages to induce ex ante overinvestment in the value of a contractual project, a tendency noted above. Efficiency requires a party to account for the fact that its investment will be wasted if its counterparty breaches. The prohibition on negative damages dis-
courages excessive investment that occurs when a party does not internalize the prospect of the other party’s breach as the prohibition implies that the nonbreaching party will pay no damages regardless of how little it would have valued mutual performance. A change in the law that would permit negative damages would reverse this result and encourage overinvestment.

Consider, for example, a modified version of the prior part’s Algernon Blair illustrations. A contractor agrees to construct a landowner’s building over a period of time in exchange for $20 million. At the time of contract, the parties anticipate the possibility of an exogenous event, or a set of exogenous events, that would simultaneously reduce the value of the building to a range between $18 million and $20 million, depending on the landowners’ prior investment in the project, and increase the contractor’s cost of completion to a range between $20 million and $22 million, depending on the contractor’s investment in precaution. If negative damages were allowed, anticipation of such an event or events would provide an incentive for wasteful investment by both parties. To see this, note that even where the value-reducing contingency is realized, the landowner would like the value of the building to be near $20 million because, if the contractor repudiated, the landowner’s liability would decline as its benefit from performance approached the contract price; similarly, the contractor would like its cost to be near $20 million because, if the landowner repudiated, the contractor’s liability would decline as its cost approached the contract price.

This said, the incentive to overinvest, induced by negative damages, would have an offset. Just as the prospect that a party might pay negative damages gives it an incentive inefficiently to reduce its costs or increase its benefits, the prospect that the party might receive negative damages mitigates, and may reverse, that inefficient incentive. In the current illustration, for example, in absence of negative damages, the contractor can profit from the contract only if its
realized costs are below the contract price and thus the contractor will want to reduce these costs even if it anticipates that the landowner will breach. Were negative damages permitted, however, the contractor would anticipate a positive probability that it would repudiate the contract and collect damages from the landowner, damages based on the difference between the contract price and value of performance to the landowner, not on the contractor’s own costs; under these circumstances the contractor’s investment in cost reduction would prove wasted and the prospect of such waste will reduce its incentive to lower its cost. A parallel story can be told about the landowners’ incentives and thus negative damages will not unambiguously exacerbate the overinvestment incentive. Still, the prospect of such exacerbation may be counted as a potential cost of negative damages.

To be sure, any wasteful investment induced by negative damages could be reduced if the law allowed negative damages only where the party in breach otherwise would have performed. In this illustration, whether the contractor or landowner repudiated, the other would have, and so a court could decline to award negative damages; as a result neither party would overinvest in anticipation of such damages. But a determination that neither party would have performed would be difficult for a court even where a calculation of negative damages would be relatively easy. Consider, for example, the illustrations in part III(A) above. There, when the contractor breached, a court could award negative damages based exclusively or primarily on the difference between the contract price and the market price for the value of performance or the

62 Compare Craswell’s observation that an insecure party should be permitted to make a termination decision only if there would be no uncertainty about that party’s willingness to perform but for its insecurity. See Craswell, cited in note 17 at 426.
cost of cover; the court would not have to determine the contractor’s costs, which might be difficult. Were the value of performance itself difficult to measure, even straightforward negative damages could be difficult to calculate, but conditional award increases the information required for a correct determination. Consequently, allowance of negative damages subject to the condition that the breaching party would have performed might be unworkable even where an unqualified allowance of negative damages could function.

The current illustration raises another concern about the disallowance of negative damages. Although the potential benefits of negative damages, discussed above, turn in part on the presence of asymmetric information, sometimes information between the parties is symmetric. Assume symmetric information here, and for now assume also that information is complete. Under these assumptions, where the contractor’s realized cost of completion exceeds the contract price and the landowner’s realized benefit is below the contract price, one party or the other will repudiate the contract regardless of whether negative damages are allowed. If negative damages were allowed, there would be a race to repudiate. In this simple illustration, ex ante investment aside, the race is costless. Matters change, however, if one assumes that the cost or benefit of completion is uncertain.

Assume that the contractor’s direct costs of completion are below the landowner’s benefit but assume also that there is a chance the contractor will discover an alternative project, one that would raise its costs, including opportunity cost, to an amount above the landowner’s benefit.

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63 In one of those illustrations, the amount of negative damages would be reduced by the transactions cost of cover—described above as the dislocation cost caused by substitute performance—but this amount, while perhaps difficult to estimate, might not be substantial relative to the overall damages and, moreover, would not determine whether damages would be awarded at all.

64 Compare Edlin, cited in note 14, where a race to repudiate would undermine a contract designed by the parties to make repudiation by one of the parties impossible, thus vesting in the other any incentive to repudiate. As
Assume, however, that only search will reveal whether the contractor has this (mitigation) opportunity and that neither the contractor nor the landowner has an advantage over the other in search, perhaps because the contractor’s skills are general. That is, assume that information is incomplete but symmetric. Under these assumptions, the disallowance of negative damages may be efficient. Given such disallowance, the landowner could simply, and credibly, announce that it will not negotiate for termination, then search, alone and optimally. Upon any discovery of a mitigation opportunity for the contractor, the landowner would repudiate, force mitigation, and capture the entire surplus from termination. Were negative damages permitted, either party could benefit from repudiation of the contract and each might have an incentive to search. This could be suboptimal as a shared benefit from search for a substitute project could lead to wasteful duplicative search or perhaps costly negotiation to avoid such excess.\(^{65}\)

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

Edlin himself observes, such contracts are not uniformly useful, as they are less than ideal when it is efficient for both parties to invest in the contractual project.

\(^{65}\) A standard result in search models such as this is that a race produces too much search because no searcher internalizes the loss suffered by a rival. See Jean Tirole, *The Theory of Industrial Organization* 396 (MIT Press 1988). It is possible to alter standard assumptions about the cost, utility, and timing of search by each of multiple parties such that multiple-party search becomes efficient. Suffice it to say here that such outcome would not be assured. Cohen, cited in note 16, makes a similar point with the observation that a buyer and seller on a sales contract may compete to find a higher-value third-party buyer. Contrast MacIntosh & Frydenlund, cited in note 18, which assumes, without analysis, that the potential for duplicative search for a mitigation opportunity is beneficial.
Consider the following version of the prior illustration. A risk neutral contractor agrees to construct a risk neutral landowner’s building over a period of time in exchange for $20 million. The value of the building to the landowner is at all relevant times $22 million and (for simplicity) no other contractor can do this work. At the time of contract, both parties anticipate that the contractor’s cost of construction will be just under $20 million. Subsequently, however, the contractor has an opportunity to bid on another project, one that would yield the contractor $4 million in profit if its bid is accepted. (Alternatively, one might simply assume that there is a chance the contractor’s direct costs of completion will increase by $4 million.) Both parties assess a 75% probability that the contractor can win this project, which it cannot complete and still perform on its contract with the landowner. (Or the parties assume that there is a 75% chance of an increase in prospective costs.) Assume that these values are verifiable to a court (which would not always but could sometimes be the case). Were negative damages permitted, the landowner would repudiate, given the chance. To see this, note that if the landowner did not repudiate, it would receive either performance or expectation damages, each worth $2 million; if it repudiated, it would expect .75($4 million), or $3 million, which is the contractor’s expected loss from performance.\(^6\) In anticipation of this, the contractor would try to repudiate first, pay the landowner $2 million in damages and retain its expected $3 million in profit from the alternative job (or avoid an expected direct loss in that amount). If repudiation terminated the project, though, the parties would forgo the 25% probability that performance rather than termination would have been in their mutual interest. The disallowance of negative damages eliminates the landowner’s incentive to repudiate early, and thus also eliminates the contractor’s incentive to do so (even if

\(^6\) For simplicity the distinction between an ex ante and ex post calculation of damages is ignored. For a general discussion of this distinction, see, e.g., Royce de R. Barondes, An Alternative Paradigm for Valuing Breach
delay in termination were somewhat costly, in the landowner’s forgone mitigation opportunity, for example).

The formality of repudiation would not necessarily mean that possibly efficient continuation would be forgone, because the parties might renegotiate post-repudiation to postpone termination of the project until the realization of the project’s true cost. But such negotiation itself could be costly. Moreover, in anticipation of such race to repudiate, each party might inefficiently search from the time of contract formation for information that would put it in a position to recognize early any expected efficiency from termination. Such advanced notice would allow a party to repudiate first and thus establish the expected surplus from termination as its reservation price in the negotiation over continuation. As a result, in this illustration, for example, the contractor and landowner might search for the contractor’s mitigation opportunities (or otherwise for information about prospective cost increases) before such search was justified by the expected benefits. Not even the prospect of costless renegotiation post-repudiation would eliminate such wasteful investigation in anticipation of a race. Again, a disallowance of negative damages for a party who would have repudiated regardless could, in principle, call off the race and imbue the parties with more efficient incentives, but, again, administration of such a rule could prove difficult.

The competition that would be inherent in the allowance of negative damages, then, could lead to too much search while continuation remained likely to be efficient and too little search (or patience) after efficient termination became more likely, a situation that could be remedied perhaps only through costly renegotiation. Because disallowance of negative damages can, at least in some instances, assign the benefits of search to a single party, disallowance may have effects.

alleviate, not exacerbate, the problems of inefficient search and termination decisions. In particular, where information is likely to be symmetric, the disallowance of negative damages is most easily justified.

This said, with reference to these illustrations, one might imagine that the law could invest the contractor with a unilateral right to repudiate and collect negative damages but deny the landowner the right to repudiate or force mitigation, whether or not the landowner would have breached absent the prospect of negative damages. In the illustrations, such a rule would generate all the benefits of one that permitted negative damages and at the same time would avoid the risk of a repudiation race. It is important to keep in mind, however, that these illustrations include the simplifying assumption only the contractor, and not the landowner, could be induces efficiently to repudiate by an award of negative damages. One could alter these illustrations so that, ex ante, it would be uncertain which party might efficiently breach if and only if negative damages were awarded and so no categorical rule would function effectively. Put another way, the apparent one-sidedness of the negative damages problem is merely an artifact of these illustrations, which like all illustrations attempt to isolate on particular issues. At least for some parties, the true nature of the negative-damages problem is bilateral and requires a bilateral solution.

V. Express Terms

The difficulties and tradeoffs described in parts III and IV may not all be inevitable, of course. If the law’s disallowance of negative damages imposes greater cost than benefit, the simplest response is an explicit contract provision that authorizes such damages. Even if, at the time of contract formation, the parties do not anticipate an advantage to negative damages, they can, in theory, negotiate for such damages at the time any such advantage is realized. To avoid the search underinvestment problem identified in part III(A), for example, the parties might negoti-
ate, ex post, for the contractor’s right to collect negative damages upon termination; this would induce the contractor to search optimally. But, as noted above, information asymmetry over the value of this option would make such negotiation difficult, perhaps prohibitively so. On the eve of a termination decision, the contractor may have a clear idea of how much search is optimal and how likely termination will be at the close of such search. Indeed the contractor may know that termination is efficient, and thus should be willing to pay a high price for the option to collect negative damages if the alternative is to perform inefficiently. Yet the landowner does not know what the contractor’s likely opportunities are and thus may assume that a contractor expressing willingness to pay only a small price for a negative-damages option is dissembling.

A key observation here is that the contractor would attempt to prove it has no alternative project and little prospect of finding one. In doing so, the contractor might convince the landowner that the contractor is likely to perform and thus unlikely to collect negative damages; a low price for the negative-damages option would thus be reasonable. Even if the contractor is truthful, however, it is difficult to demonstrate a null set. A bargain might not be possible at all under these conditions, at least not before the time for performance has arrived.

Compare what Brooks describes in a recent article (drafted contemporaneously with this one) as the doctrine of efficient performance (as opposed to efficient breach). Brooks observes that there is no immutable, or even natural, connection between the allocation of surplus in the case of efficient breach, and the realization of that surplus. The law, he reasons, could award the surplus (or almost all of it) to the promisee and thus tackle the philosophical objections, noted above in part I, to the promisor’s enrichment from his own breach. Brooks proposes that, in the event of repudiation, the law grant the promisee an option to receive disgorgement damages—
the difference between the promisor’s cost and the contract price—or insist on specific performance. He does not address negative damages, or the prospect that the absence of such damages would prevent repudiation in the first instance, but his analysis of the breach victim’s incentives post repudiation raises issues parallel to those addressed here, including on the question of renegotiation.

Consider, for example, a case in which the promisor repudiates a contract while the promisee possesses private information about the value of performance to the promisee; the promisee knows that performance is efficient while the promisor mistakenly believes otherwise. Under the rule that Brooks proposes, the promisee would insist on specific performance, which is, by hypothesis, more valuable than disgorgement damages and there would be no need for renegotiation. In this context, however, avoidance of renegotiation may not be greatly meaningful. This is so because, where performance is efficient, ordinary expectation damages may relatively easily yield an efficient continuation decision, despite initial information asymmetry, as neither party has even a private incentive to permit termination of the project. Under a true expectation remedy, the promisee is indifferent between damages and performance and thus would not benefit if it dissembled in negotiation with the promisor over the performance decision. Indeed, it may be quite common for parties to negotiate in advance of repudiation, and one might expect that in the course of such negotiations promisees frequently convince promisors simply to perform where performance is efficient; the promisors have an incentive to do this, rather than await a damages remedy, because, in practice, the costs of project termination are not fully reflected in the expectation award. By contrast, where breach is efficient but inhibited by information

67 See Brooks, cited in note 1.
68 See Craswell, cited in note 17.
asymmetry—i.e., where negative damages are required to yield efficient breach—an optimal result is not so easily realized.

Given the pressures on negotiation at the time of a termination decision, just summarized, parties might agree earlier, at the time of contract formation, to a negative-damages clause. At the time of contract formation, the value of a negative-damages option may not be difficult for either party to estimate fairly, albeit imprecisely, or at least any difficulty in estimation may not be substantially greater than the estimation of the breach option generally, one without a negative damages component. That is, far in advance of the termination decision, information asymmetry may be relatively mild. And at the time of contract formation, without an impending performance decision, there is time to resolve any asymmetry that does exist.

Nevertheless, parties do not, in fact, include negative-damages provisions in their contracts, or at least such provisions are not common, either at the time of contract formation or thereafter. A reason may be that parties rarely if ever anticipate that the benefits of a negative-damages clause will outweigh the costs. But this is not necessarily the case. Even if one assumes that for some parties the allowance of negative damages would trump simple disallowance, without more, there are a number of possible explanations for the absence of negative-damages clauses. Parties may predict that a negative-damages clause would be unenforceable as unconscionable (and, thus, that the disallowance of such damages is a mandatory, rather than default, rule). It is also possible that no party wishes to bear the potentially negative signal a negative-damages clause might send about that party’s quality as a contractual partner. Also, as Shavell has observed, and as noted above in part II, the parties may lack the information necessary to fashion productive, verifiable rules to govern the breach or performance decision, otherwise the
expectation remedy itself would be unnecessary.\textsuperscript{69} Thus, because the parties cannot easily limit the allowance of negative damages to circumstances where they would be beneficial, they may accept the default rule of expectation damages or adopt alternative terms that avoid the default.

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

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

\textsuperscript{69} See Shavell, cited in note 21, and accompanying text. See also note 44.
a negotiated cure to this underinvestment problem might prove impossible. Thus, the problem of part III(A) would not be solved entirely. Moreover, neither a liquidated-damages clause nor a specific-performance clause would adequately address the contractor’s continuation bias, borne from variance in judicial estimation, illustrated by part III(B). Similarly, neither clause would reduce the incentive for strategic use of the material breach doctrine, the illustration in part III(C). Further, although, in a related context, Edlin has shown that clauses such as this can sometimes be fully efficient,\(^{70}\) in some settings either type of clause has the potential to induce excessive reliance on performance, even more so than expectation damages, and so parties might be hesitant to employ a draconian remedy that they must negotiate themselves out from under, perhaps even under conditions where both parties would easily recognize the efficiency of contract termination.

Still, some parties to some contracts might rationally choose high liquidated damages or specific performance to balance competing concerns, including search incentives. Thus, the prohibition on negative damages as part of the expectation remedy, which contributes to the need for such balance, provides an argument, supplemental to those extant,\(^{71}\) for judicial enforcement of so-called “penalty” clauses and of specific-performance clauses.

VI. **The Mitigation Doctrine**

In principle, the expectation remedy awards the victim of breach its loss from the failure of performance less any part of the loss the victim could have avoided. Consider once more the above illustrations where a contractor agreed to construct a building for a landowner. When the contractor repudiated and the landowner valued the building by more than the price of substitute

\(^{70}\) See Edlin, cited in note 14.
performance, the landowner’s expectation damages were measured by the difference between the market price for performance and the contract price (plus any other injury caused by the breach) not by the difference between the value to the landowner of the building and the contract price. If the landowner failed to hire substitute performance, the consequential loss would be borne by the landowner, not the contractor. Doctrinally, a court would say that the landowner failed to mitigate its injury from the contractor’s breach. This is the theory, in any case.

In application of the mitigation doctrine, the victim’s duty to mitigate is limited. The victim need not accept an alternative project in mitigation unless the alternative is almost fungible with the contractual project. In a now famous example, the actress Shirley MacLaine (Parker) was under contract with Fox to perform in the movie “Bloomer Girl.” Fox cancelled the movie and requested that she act in a substitute movie, “Big Country, Big Man.” MacLaine declined yet won damages from Fox for its repudiation of the Bloomer Girl contract, damages unreduced by MacLaine’s refusal to mitigate with earnings from Big Country. As stated by the California Supreme Court, the duty to mitigate does not extend to a project that is “inferior” in quality to the contractual project.72

Ostensibly, this limitation is inconsistent with efficient breach theory. It might seem that a better rule would require the victim to mitigate with any alternative project if the project would reduce damages to any extent, even if the alternative project is somewhat unsatisfactory to the victim of breach and thus would not fully eliminate damages. Edlin, for example, has argued for this result.73 As the law stands, given cases such as Parker, although a victim of breach must

71 See, e.g., Lars Stole, Liquidated Damages with Private Information. 8 J.L. Econ. & Org. 582 (1992).
mitigate with work at an inferior price, she may avoid mitigation if the work is of inferior quality even if efficiency would require her to accept such work. The mitigation obligation, then, may seem wastefully weak.

The analysis of this essay, however, suggests that the current limitation on the mitigation obligation might be the better rule after all, at least as a default. Consider one last time the above construction contractor illustrations from part III(A). Under the law’s limited mitigation obligation, the contractor may freely approach the landowner and engage in an informed negotiation over the terms of termination. If the mitigation obligation were unlimited, the contractor could not inform the landowner of a mitigation opportunity without fear that the landowner would simply repudiate and capture the entire surplus from termination. In anticipation of this outcome, or of a negotiation plagued by information asymmetry, the contractor might forgo an efficient termination or have little incentive to search for a mitigation opportunity. Thus, the limitation on the mitigation obligation enhances the contractor’s ability to exploit a known mitigation opportunity and provides the contractor an incentive to search for such an opportunity, albeit an incentive weakened by the prospect that it will have to share the benefits of termination.

In this context, the limited mitigation obligation may be seen as a compromise between the allowance of negative damages, which would provide a robust incentive for efficient repudiation, and disallowance which avoids the costs of a repudiation race, as described above in part IV. The result is similar to that of a liquidated-damages clause or a specific-performance clause, described above in part V, in that, like these clauses, the limited mitigation obligation effectively prevents unilateral promisee repudiation, but the limited mitigation obligation does not introduce the same potential for general overinvestment incentives.
CONCLUSION

The analysis offered here identifies a gap in contracts theory scholarship on the topic of negative damages, a topic that might also be referred to as expectation damages in the case of victimless breach. The prohibition on negative damages likely imposes some costs, where a promisor has private information that breach is efficient but profits from the contract, for example, and generates some benefits, where a costly repudiation race would otherwise ensue, for example. The balance should perhaps be left to the parties, though the prospect of adverse selection may call into question the efficacy of such choice if a party might favor a negative-damages clause but for the signal such adoption would send to her counterparty. Adverse selection aside, where parties do not adequately consider breach remedy at the time of contract formation, it is possible that efficiency would be served if as a default rule negative damages were permitted rather than prohibited, at least under circumstances where the court determines (difficult though this may be) that the party in breach would not have breached but for the allowance of negative damages; this default might be appropriate if one assumed that negotiation over a negative-damages clause would be expensive or impossible post-formation. These and other questions require further analysis; this essay is but a step toward a general theory.

There is a practical aspect to this analysis as well, even under current law. The arguments contained in this essay, even in incomplete form, should give courts pause, or additional pause, before they insist on an expectation remedy and disregard a contract clause for liquidated damages or specific performance. These arguments, moreover, offer some support for the common law limitation on the obligation to mitigate.
Appendix

Consider a contractual relationship with the following characteristics:

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

It follows that:

- Termination is efficient iff $C > B$;
- Promisor will repudiate when $C - P > D$;
- When $D = B - P$, the promisor will repudiate iff breach is efficient.
- Ex post efficiency is served, then, if $B$ and $P$ are observable and thus verifiable even if $C$ is not.

Further:

- Repudiation is efficient iff $C > B$;
- Promisor will repudiate when $C - P > D$;
- Because $D = \max(0, B - P)$, where $B - P$ is negative, it is possible that:
  - $C - P < D$; and
  - $C > B$.
- That is, the promisor may have an inefficient incentive to perform.

Thus:

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