Intentional Interference with Contractual Relations: A Transactional Approach

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The tort of intentional interference with contractual relations has posed a persistent puzzle for scholars of contract law, and especially for those scholars following an economic approach. Stated from a traditional doctrinal perspective, the puzzle is this: we do not ordinarily regard contract breach as a punishable wrong, and we do not ordinarily award punitive damages as a remedy for breach. Why then do we punish contract breach when it occurs at the instigation of a third party? Stated from a law-and-economics perspective: the puzzle is this: remedies for breach should be understood as an implicit term of the contract, one that can and should be chosen to maximize the expected parties' surplus from exchange. If the remedy is properly chosen between the parties (for example, suppose they are in a situation where expectation damages are best because they provide efficient incentives for performance, as in the standard model of efficient breach), why would we ever wish to impose additional damages on a third party? By hypothesis, the incentives for breach have been optimally chosen (or balanced against other incentives such as efficient reliance or risk allocation in a manner that is second-best efficient). Won't additional liability simply upset the tradeoff that is best for the parties?

Various answers have been offered for this puzzle.[1] Richard Epstein, for instance, has proposed an explanation in terms of the ostensible ownership of

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[1] In addition to the individual articles discussed below, see Dan B. Dobbs, Tortious Interference with Contractual Relationships, 34 Ark. L. Rev. 335 (1980); Harvey Perlman, Interference with Contract and Other Expectancies: A Clash of Tort and Contract Theory, 49 U. Chi. L. Rev. 61 (1982), Benjamin L. Fine, Note, An Analysis of the Formation of Property Rights Underlying Tortious Interference with Contracts and Other Economic Relations, 50 U. Chi. L. Rev. 1116, 1125-26 (1983); Gary Myers, The Differeing Treatment of Efficiency and Competition in Antitrust and Tortious Interference Law, 77 Minn. L. Rev. 1097 (1993) ; Gary D. Wexler, Intentional Interference with Contract: Market Efficiency and Individual Liberty Considerations; 27 Conn. L. Rev. 279 (1994-1995); Mark P. Gergen, Tortious Interference: How It Is Engulfing Commercial Law, Why This Is Not Entirely Bad, and a Prudential Response, 38 Ariz. L. Rev. 1175 (1996); William J.

property: in his formulation, the tort encourages those who have entered into contracts the incentive to make public the fact that they have done so, thus protecting themselves from interference and others from the wasteful efforts involved in pursuing a contract with a promisor already obligated to another.[2] William Landes and Richard Posner have suggested that the tort is useful in cases where full recovery against the breaching promisor is infeasible due to insolvency or litigation costs, making the tortfeasor into a sort of involuntary guarantor.[3] Lillian BeVier suggests that the tort fills in the gaps when, for various reasons, contract damages are undercompensatory.[4] Most recently, Fred McChesney has argued that tortious interference is appropriate (and in positive terms, actually tends to be found) in situations in which transaction costs make a property rule more efficient than a liability rule as a way of protecting contractual rights.[5]

None of these analyses, however, take into account the possibility that the parties themselves might contract ex ante over the issue of future dealings with third parties who may be interested in the subject of the underlying exchange. For example, real estate brokerage contracts typically provide for the broker to receive its fee, in whole or in part, if the seller should sell the property outside of the broker's agency; they also place limits on any exclusive period of agency. Prospective purchasers in corporate takeover agreements typically bargain for substantial breakup fees payable in the event that the target company backs out of the deal. And parties contemplating contracts that could give rise to a tortious interference claim can and do stipulate that one party or another will bear responsibility for any liability, by

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Woodward, Jr., Contractarians ; Deepa Varadarajan, Tortious Interference and the Law of Contract: "The Case for Specific Performance" Revisited, 111 Yale Law Journal 735 (2001)., 2001), pp. 735-760; David Howarth, Against Lumley v Gye, The Modern Law Review, Vol. 68, No. 2 (Mar., 2005), pp. 195-232; William Woodward, Community and the Tort of Interference with Contract, 80 Minn. L. Rev. 1103 (1996) ; Clark A. Remington Intentional Interference with Contract and the Doctrine of Efficient Breach: Fine Tuning the Notion of the Contract Breacher as Wrongdoer, 47 Buff. L. Rev. 645 (1999; Law of Contract: "The Case for Specific Performance" Revisited, 111 Yale Law Journal 735 (2001

[2] Richard A. Epstein, Inducement of Breach of Contract as a Problem of Ostensible Ownership, 16 J. Legal Stud. 1 (1987) 12.

[3] William M. Landes and Richard A. Posner, Joint and Multiple Tortfeasors: An Economic Analysis, 9 J. Legal Stud. 517 (1980). See also Richard A. Posner, Common-Law Economic Torts: An Economic and Legal Analysis. 48 Ariz. L. Rev. 735, 743-745 (2006).

[4] Lillian BeVier, Reconsidering Inducement, 76 Va. L. Rev. 877 (1990).

[5] Fred S. McChesney, Tortious Interference with Contract Versus "Efficient Breach": Theory and Empirical Evidence, 28 J. Legal Stud. 131 (1999).

providing for indemnification, warranties of clear title, or both. Indeed, the infamous case of *Texaco v Pennzoil,* which resulted in what was at that time the largest bankruptcy proceeding in American history and which is probably single-handedly responsible for the revival of legal scholars' interest in the tort of interference soon thereafter, involved just such a clause.

Accordingly, this paper, aims to investigate the incentive effects of the interference tort in cases where it is possible to contract ex ante over interference liability, and to distill any principles of transactional planning that may follow. The analysis will also help, I hope, in distinguishing between two very different types of cases currently treated under the same doctrinal rubric of intentional interference — cases that are indirect contracts cases because the defendant is in privity or potential privity with the plaintiff's contractual counterparty, and cases that are true torts.

The paper is organized as follows: section 1 outlines the methodological perspective on which the paper's analysis is based, which I call the transactional approach to analyzing contract doctrine. Section 2 then summarizes the main features of tortious interference doctrine, and its asserted tension with the law of contracts. Section 3 surveys and assesses the main proposals for resolving this tension that have been offered in the academic literature; and Section 4 contrasts these proposals with the resolution offered by the transactional approach. [Section 5, to be completed in a subsequent draft of the paper, will extend the analysis to other three-party interactions, and will discusses some specific contractual devices that parties might use to pursue their ends in such situations, I will present some of these extensions in my oral presentation.] Section 6 then recapitulates the advantages of the transactional approach and offers conclusions.

1. Some methodological groundwork: the transactional approach

A brief methodological word is useful before proceeding to the main discussion The analysis presented here is part of a larger scholarly project, the goal of which is to develop a set of basic account of contractual design for use in understanding transactional planning.[5] The primary audience for this project is not courts or

[5] Other contributions to this project include Avery W. Katz, Taking Private Ordering Seriously, University of Pennsylvania Law Review, 144(5), May 1996, pp. 1745-1763 ; Avery W. Katz, An Economic Analysis of the Guaranty Contract. University of Chicago Law Review, 66(1), Winter 1999, pp. 47-116; Avery W. Katz, The Economics of Form and Substance in Contract Interpretation. Columbia Law Review, 103(2), March 2004, pp.

legislators. Instead it is teachers of contract law, and to a lesser extent their students. The project is intended as a corrective to the over-emphasis on legal reform found in law teaching and in the academic literature on the economics of contract law. Its premise is that private actors designing their own transactions are a much more relevant audience for economic analysis than are public officials, for three reasons. First, private lawmakers have a direct interest in using contract planning to shape ex ante incentives and in interest in making their transactions more efficient. Public officials, in contrast, are interested in a variety of goals beyond efficiency, and in their judicial roles are likely to be at least as focused on pursuing ex post corrective justice as on ex ante incentives. Second, private lawmakers are in a better position than public officials actually to make use of economic insights. They are more likely to be in possession of the detailed information that is necessary to apply such insights usefully in specific contexts. And their flexibility in changing their practices is much less institutionally constrained. And third and finally, relatively few contracts are enforced in court; and while the shadow of the law does influence behavior outside the legal system, contracting parties in a wide variety of settings are at least as motivated by non-legal sanctions such as reputation.[6]

The distinction between a law reform perspective and a transactional one can be illustrated by the example of efficient breach theory. [7] From a law reform perspective, efficient breach is either a justification for the primacy of the expectation principle in legal doctrine, or a theory of how courts should interpret legal doctrine

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496-538; Avery W. Katz, The Option Element in Contracting, Virginia Law Review, 90(8), December 2004, pp. 2187-2244.; Avery W. Katz, Contractual Incompleteness: A Transactional Perspective. Case Western Reserve Law Review, 56(1), Fall 2005, pp. 169-186; Avery W. Katz; Remedies for Breach of Contract under the CISG. International Review of Law and Economics, 25(3), September 2005, pp. 378-396; Avery W. Katz; Contractual Enforcement Institutions and the Structure of Information. Journal of Institutional and Theoretical Economics, 164(1), March 2008, pp. 134–154.

[6] See e.g., ; Stewart Macauley, Non-Contractual Relations in Business: A Preliminary Study, 28 American Sociological Review 55 (1963); Arthur Allen Leff, Injury, Ignorance and Spite—the Dynamics of Coercive Collection, 80 Yale LJ 1, 24-26 (1970); ; Robert C. Ellickson, Of Coase and Cattle: Dispute Resolution among Neighbors in Shasta County, 38 Stan. L. Rev. 623 (1986); David Charny, Nonlegal Sanctions in Commercial Relationships, 104 Harv L Rev 373, 391-446 (1990); Lisa Bernstein, Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry, 21 J. Legal Stud. 115 (1992).

[7] What follows is an abbreviated version of the analysis presented in Avery Katz, Virtue Ethics and Efficient Breach, 45 Suffolk. UL Rev. 777 (2012).

governing contracts damages.[8] From a transactional perspective, however, it is better viewed as a theory of how parties should specify the conditions under which they have a duty to perform — and from that perspective the term "efficient breach" is less than helpful. A more apt term, and one that does not carry the same normative baggage, would be "efficient termination option".

To illustrate more concretely, consider the example of a homeowner who wants her driveway repaved and is shopping for a contractor. The homeowner places some reservation value on the repaving work; suppose without loss of generality that this reservation value, including the monetary equivalent of all intangibles, equals $2000.[9] The homeowner searches online and finds three possible contractors. The first promises to finish any job it undertakes, no matter what. The second does not promise to finish no matter what, but does promise to insure that the homeowner receives the value of her expectation, either by performing, or by making a payment equal to the homeowner's reservation value (including any costs of cleanup or reliance investment). The third contractor does not promise to finish no matter what and does not even promise to pay the customer's lost expectation interest, but it does promise that if it does not finish it will clean up any mess that it leaves and cheerfully refund any deposit it has received.

For the homeowner, choosing among the three contractors is equivalent to choosing among specific performance, expectation, and reliance damages. In this hypothetical market, contracting for specific performance will be more expensive than contracting for expectation, because the cost of performing no matter what is higher than the cost of performing or paying expectation, whichever is less. (Similarly, contracting for expectation will generally be more expensive than contracting for reliance, if we assume that the contract is a welfare-increasing one for the homeowner.) If the homeowner is entering into the exchange for instrumental

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[8] See, e.g., Robert L. Birmingham, Breach of Contract, Damage Measures, and Economic Efficiency, 24 Rutgers L. Rev. 273 (Winter 1970), Richard Posner, Economic Analysis of Law (1973), pp. 55-59; Charles J. Goetz & Robert E. Scott, Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach , 77 Colum. L. Rev . 554 (1977); Robert Cooter & Melvin Aron Eisenberg, Damages for Breach of Contract, 73 Calif. L. Rev. 1432 (1985 Steven Shavell, Contracts, in The New Palgrave Dictionary of Economics and the Law 436, 439 (Peter Newman ed., 1998).

[9] If $2000 is not enough to cover the value of intangibles, then increase the termination payment until it does. The point of the assumption is that the homeowner attaches finite value to completion of the driveway and that this value can be expressed in monetary terms.

reasons (that is, all she cares about is what she receives when the parties' interaction is complete, and not the process by which she receive it) then her consumer surplus will be highest if she chooses the second contractor — that is, if she chooses expectation damages.[10] Conversely, if the homeowner does care about performance for its own sake, in a way that is not commensurable with money, for the instrumental benefits it provides, then it could well make sense for her to choose the first contractor. But note that in so doing she must sacrifice consumer surplus as it is ordinarily measured.

There are other reasons why a homeowner might prefer one contractor over another. For instance, she might worry that the amount she receives as compensation for nonperformance from the second contractor might be less than her actual expectation interest – either because of measurement error, or because her value from performance has increased between the time she enters the contract and the time the contractor decides to perform. But of course such factors might equally well run the other way. The homeowner's value of performance could alternately decrease; and if she chooses the first contractor there might also be measurement error in determining whether its performance in fact complies with what was promised.

The key point is that framing efficient breach in transactional terms rather than remedial ones forces an ex ante perspective, and makes clear why parties might or might not choose to live under a legal regime that prescribes it. The same is true for other elements of contractual design and other rules of contract law. And the same is true for non-contractual doctrine such as tortious interference.

The pros and cons of tortious interference liability can be isolated through a similar exercise, though the reasoning is more complex because we must now consider the behavior of a third party. Before turning to that analysis, it is necessary to outline the main features of the legal doctrine in this area.

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[10] For a more systematic account of the reasoning underlying this example, see Steven Shavell, Specific Performance Versus Damages for Breach of Contract: An Economic Analysis, 84 Tex. L. Rev. 831, 867 (2006); and Steven Shavell, Is Breach of Contract Immoral?, 56 Emory L.J. 439, 439 (2006). Note that the argument is not affected by risk aversion as it is conventionally conceived by economists, because the homeowner faces no risk when dealing with the second contractor — she is still guaranteed $2000 worth of value. Whether she received it in the form of a driveway or in the form of cash is irrelevant from an instrumental perspective.

2. The law of tortious interference

Under the common law, a party who suffers a breach of contract is entitled to recover in tort from a third party whose improper interference induced the breach. This right is over and above any claim for contract damages the aggrieved party may have against the breacher. [11] Damages for the same injury may not be recovered twice, but it is possible for the aggrieved party to recover compensatory damages from the breacher, and exemplary or punitive damages from the inducer.

The inducement tort dates back to the celebrated English case of *Lumley v. Gye*.[12] *Lumley v Gye* was a companion case to *Lumley v Wagner*, in which a theater owner sued an opera singer for breaching a contract to sing at his theater in order to enter a more lucrative contract with the owner's competitor. The aggrieved owner, Lumley, succeeded in obtaining an injunction that enforced a non-compete clause in the singer's contract, although he did not manage (nor did he attempt) to force the singer to perform at his own theater as promised. In the end, the singer, a German mezzo-soprano national, never sang at either theater and in fact was kept off the English stage for over four years. For his part, Lumley never received any damages from Wagner and had to close his theater.[13]

Most American lawyers and law students are likely to remember *Lumley v Wagner* as standing for the dual proposition that while the remedy of specific performance is not available to enforce affirmative duties owed under contract for personal services,

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[11] Restatement (Second) of Torts § 766 (1979) provides: "Intentional Interference With Performance Of Contract By Third Person. One who intentionally and improperly interferes with the performance of a contract (except a contract to marry) between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract."

[12] 2 El. & Bl. 216, 118 Eng.Rep. 749 (1853). More precisely, *Lumley v. Gye* was the first case in which liability for interference was found on the basis of actions that were not themselves independently tortious. Earlier antecedents included the medieval Statute of Laborers, which prohibited the movement of workers from their home areas and provided sanctions against landlords who enticed such movement by promising improved conditions and, before that, the right of the paterfamilias under Roman law to recover damages from those who interfered with his exercising authority over members of his household. See F. Sayre, Inducing Breach of Contract ,36 Harv L Rev. 663 (1923).

[13] For additional details, see Lea S. VanderVelde, "The Gendered Origins of the Lumley Doctrine: Binding Men's Consciences and Women's Fidelity," 101 Yale LJ 775 (1992), presents a provocative and thoughtful discussion of the gender and class politics aspects of the case and of the doctrines that developed from it.

it is available to enforce negative duties owed under a covenant not to compete. They will probably be less familiar with *Lumley v Gye*, which falls at the boundary between contract and tort and which therefore is rarely taught in either contract or torts classes. In *Gye*, Lumley sued his competitor for the financial losses he suffered as a result of having to cancel the engagement with Wagner. Gye demurred to the claim; and the Queen's Bench overruled the demurrer and held that Lumley had stated a good legal claim. In the end, Gye won the case; he argued on remand that he had honestly (though perhaps unreasonably) believed that Wagner was legally entitled to terminate her contract with Lumley. The trial judge instructed the jury that scienter was necessary for a finding of liability; and the jury found no scienter.[14] But the legal principle that liability would lie if there were scienter remained, and was expanded in cases that followed.[15]

Today, modern doctrine continues to require scienter (it is, after all, an intentional tort) but the nature of the required state of mind has been watered down. "Malice" is not required; all a plaintiff must show to make out a case for liability under the Restatement of Torts is that (1) a contract to which it was a party existed, (2) the defendant knew the contract existed, (3) the defendant improperly interfered with the contract, (4) the interference resulted in nonperformance of the contract, (5) the nonperformance caused damage to the plaintiff.

Note that under the Restatement, liability in tort can attach even if there is no breach of contract; all that is needed is nonperformance. A defendant who induces a contracting party to exercise her bargained-for right of termination may be liable for the other party's losses, if the inducement is found to be improper.[16] The contract need not even be fully enforceable; courts have held that one who induces a contracting party to avoid a voidable contract (for example by asserting the Statute of Frauds or a defense of mistake) may be liable for the counterparty's pecuniary losses.[17] Some jurisdictions even extend the principle to protect business relations

[14] Stephen M. Waddams, "Johanna Wagner and the Rival Opera Houses" (2001), 117 Law Q. Rev. 431 (2001).

[15] For a discussion of the doctrine's further development, see F. Sayre, supra, note __ .

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[17] [Citation to be provided]

that have not yet ripened into contract, such as opportunity to bargain or loss of business goodwill.[18]

As a practical matter, the key question in any interference case (apart from establishing that the defendant knew what it was doing) is whether the interference was improper. Interference that itself is tortious (for example, battery, false imprisonment, or extortion) is clearly improper, but it is just as clear that otherwise non-tortious behavior can be improper interference under the right circumstances. Some types of interference are privileged: for example, a person with a direct financial interest in a business entity (for example a manager or stockholder) is permitted to discourage the entity from entering into a contract that the interested person regards as unfavorable.[19] A person looking out for the welfare of another (for example the child or physician of an elderly person) is permitted to encourage the beneficiary to withdraw from a contract that the interferer believes is not in the beneficiary's interest, so long as wrongful means are not used.[20] But all in all, the criteria for determining whether interference is improper are wide-ranging and highly contextual.[21] Even defenders of the doctrine admit that it is vague and difficult to predict in application.[22]

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[18] See Restatement (Second) of Torts § 766B (1979) (" Intentional Interference With Prospective Contractual Relation")

[19] See Restatement (Second) of Torts § 771 ("Inducement To Influence Another's Business Policy").

[20] See Restatement (Second) of Torts § 770 (" Actor Responsible For Welfare Of Another").

[21] Restatement (Second) of Torts § 767 (" Factors In Determining Whether Interference Is Improper") provides: "In determining whether an actor's conduct in intentionally interfering with a contract or a prospective contractual relation of another is improper or not, consideration is given to the following factors:

(a) the nature of the actor's conduct,

(b) the actor's motive,

(c) the interests of the other with which the actor's conduct interferes,

(d) the interests sought to be advanced by the actor,

(e) the social interests in protecting the freedom of action of the actor and the contractual interests of the other,

(f) the proximity or remoteness of the actor's conduct to the interference and

(g) the relations between the parties."

[22] See, e.g., William J. Woodward, Jr., Contractarians, Community and the Tort of Interference with Contract, 80 Minn. L. Rev. 1103, 1118 (1996) ("The perceived vagueness of the liability principle is not new; its resistance to this recurrent criticism suggests that the

The breadth of the doctrine has resulted in a body of case law that incorporates a grab-bag of fact patterns, some of which might easily have been addressed by other legal doctrines. Tortious interference claims have been raised, for instance, in situations that also sound in defamation, unfair competition, common-law restraint of trade, and trade secret law. In England, the doctrine has often been used in the area of employment law to regulate striking workers or the practice of labor organizing.[23]

For scholars writing from the perspective of tort law, this flexibility in application is not necessarily objectionable. Mark Gergen, for instance, has justified the interference doctrine as an elaboration of the more general doctrine of prima facie tort, under which any intentional infliction of harm is tortious unless the act is justified or privileged, typically on the grounds that the interferer is pursuing legitimate purposes of his or her own.[24]

Scholars approaching the topic from the perspective of contract law, however, have been less sympathetic to the doctrine. They have primarily focused on cases resembling the classic fact pattern of *Lumley v Gye,* in which a business competitor lures away a customer or supplier with the promise of a better deal. The courts have generally held that competition for the business of third parties is not improper when the aggrieved party's contractual relation with the third party is merely prospective, or when the aggrieved party has a contract with the third party that is terminable at will. But they have also found liability when competitors cause the breach of an existing contract not terminable at will.[25]

Liability for tortious interference in such cases has been controversial among contract scholars because it appears to run counter to fundamental principles of

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tort may embody strong underlying values. Perhaps the vague standards reflect a lack of consensus on the values that are being embraced as well"); Mark Gergen, , supra, note __ , at 1184 ("Courts struggle with this issue [of improperness] because the law of interference, and tort law more generally, provides little assistance in setting limits on the tort.")

[23] See David Howarth, Against *Lumley v Gye*, The Modern Law Review, Vol. 68, No. 2 (Mar., 2005), pp. 195-232 (reporting that: strikes feature in about 40 per cent of all reported English cases in which *Lumley v. Gye* has provided the basis of a cause of action).

[24] Although he argues that the scope of the tort should be limited to avoid excessive encroachment on basic policies of contract law, importantly including freedom of contract. Gergen, , supra, note __ , at __.

[25] Restatement (Second) of Torts § 768 (1979) (Competition As Proper Or Improper Interference).

contract damages: in particular, to the principles that contract remedies are based on the expectation measure and that the role of contract damages is to compensate, not to deter or punish.[26] Opposition to the doctrine has been especially strong on the part of scholars who have framed these principles in terms of a right to breach contracts so long as one pays compensatory damages to the disappointed promisee.[27]

Within the modern academic literature on contract law, of course, no group of scholars has been more committed to the idea of a right to breach contracts than scholars writing from the perspective of the economic analysis of law. Such scholars tend to argue that common-law rules should be designed (or in case of the early writings of Richard Posner and some of his followers, are in fact designed) to promote economic efficiency.[28] If it is good policy to encourage efficient breach, and if efficient breach is promoted by a rule of expectation damages, then how can a tort doctrine that imposes supracompensatory damages be a good idea?

Economicallly oriented contracts scholars have long puzzled over this question, and have put forward several answers. The next section of the paper assesses these proposed resolutions.

3. Possible economic defenses of the interference tort

One obvious way to explain the interference tort, while remaining committed to the theory of efficient breach, is to say that it operates as a supplementary doctrine in cases where ordinary expectation damages fail to provide the right incentives. This

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[26] See Dobbs, supra, note __ (arguing that the tort should be abolished on libertarian grounds as a restriction on commercial speech); Perlman, supra, note __ (arguing that the tort should be abolished in cases where the interference is not independently tortious); Myers, , supra, note __ ; Howarth, supra, note __.

[27] A position that in American law goes back as far as Oliver Wendell Holmes. See Oliver Wendell Holmes, Jr., The Path of the Law, 10 Harvard Law Review 457 (1897) ("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. If you commit a tort, you are liable to pay a compensatory sum. If you commit a contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it advantageous to get as much ethics into the law as they can."),.

[28] See, e.g., Richard A. Posner, Economic Analysis of Law, 1st[th] Ed., p.98 (1972) ("The common law method is to allocate responsibilities between people engaged in interacting activities in such a way as to maximize the joint value, or, what amounts to the same thing, minimize the joint cost of the activities.").

is the position taken by Richard Posner.[29] This explanation is quite versatile because there are many such occasions: expectation damages may fail to promote efficient breach because they are inadequately measured, because the breacher may be judgment-proof, because breach is imperfectly detected, because of countervailing doctrines such as the duty to mitigate damages and the rule of *Hadley v Baxendale*, or because the cost of bringing suit is prohibitive.[30] In such cases, interference liability enhances the incentive effect of expectation damages by ensuring that they are actually paid (or in the case of punitive damages, that they are paid in terms of expected value given that the amount of damages must be discounted by the probability of receiving them.)

An alternative explanation is to deny the efficiency of expectation damages as a general matter. On this explanation, efficiency in contracting (or in a subset of contracts) is best promoted by a property rule as opposed to a liability rule. This might be so for a variety of reasons: because expectation damages inadequately protect investment incentives, because a property rule encourages better use of private information regarding the costs and benefits of breach and investment in communication about the scope of parties' legal interests, because liability rules create incentive for opportunistic trespass, or because the transaction costs of litigating over compensatory damages are greater than the transaction costs of bargaining for a release.[31]

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[29] See Posner, Common-Law Economic Torts: An Economic and Legal Analysis. 48 Ariz. L. Rev. 735, 745 (2006) ("The sensible rule would be to refuse to impose tort liability unless the contract remedy is inadequate") .

[30] See Posner, Common-Law Economic Torts; supra, note __, at 743 (breacher may be judgment proof); William M. Landes and Richard A. Posner, Joint and Multiple Tortfeasors: An Economic Analysis, 9 J. Legal Stud. 517, __ (1980) (inducement liability operates as a form of joint and several liability when the inducer has a comparative advantage in monitoring breach); BeVier, supra, note __ (market damages are inadequate when substitute transactions are not available, either because the underlying exchange depends on the production of unique information or because the transaction arises from an ongoing relationship); Clark A. Remington, Intentional Interference with Contract and the Doctrine of Efficient Breach: Fine Tuning the Notion of the Contract Breacher as Wrongdoer, 47 Buffalo L. Rev. 646 (1999) (not every breach that contract law currently encourages is a socially desirable breach).

[31] See Epstein, supra, note __ ("[I]nducement of breach of contract is used to fill the gaps in the law of trespass or conversion [and] to fill the void that the more traditional notions of property may not reach"); . McChesney, supra, note __ (offering empirical evidence associating availability of tortious interference liability with property-rule protection more generally). [Also add string cite to literature on the relative efficiency of property and liability rules].

Some commentators have suggested that liability for tortious interference is best understood as a second-best response to deficiencies in the law of contract remedies. For instance, Deepa Varadarajan argues in a very thoughtful student note that the tort is best understood as operating as a substitute for specific performance in contexts where it is not legally available (for example, cases involving the performance of personal services like *Lumley v Wagner*); on this view the need for the tort would diminish if courts were willing to expand their use of injunctive relief.[32] A similar argument might be put forward with regard to punitive damages. While black-letter doctrine does not allow parties to contract into liquidated damages that foreseeably exceed a reasonable measure of expectation, legal economists have identified a number of situations where the use of penalties might improve joint surplus for perfectly rational actors.[33] In cases where penalties would be optimal but the law of contracts does not allow them; tortious interference (like the controversial tort of bad faith breach of contract) allows sympathetic judges an end run around unsympathetic doctrine.[34]

Such explanations have a certain surface plausibility but they do not really make the case for displacing ordinary principles of contract law. If one thinks that contract law underprotects certain types of expectation interests, surely the better course is to reform the law of contracts from within rather than using an all-purpose doctrinal trump card with uncertain limits that correspond only imperfectly with the policies that justify its use.

More importantly, a judgment that contract damages underprotect the expectation interest cannot reasonably be made at the level of contract law generally. Whether contracting parties benefit from full expectation damages, something more, or something less, will depend on a host of tradeoffs that differ across industries, markets, and individual transactions. Contract remedies do not only influence the parties' incentives whether to perform; they also influence incentives to mitigate, to

[32] Deepa Varadarajan, Tortious Interference and the Law of Contract: "The Case for Specific Performance" Revisited, 111 Yale Law Journal 735 (2001).

[33] See Aaron S. Edlin and Alan Schwartz. "Optimal Penalties in Contracts" 78 Chicago-Kent Law Review 33 (2003); cf. A. Mitchell Polinsky & Steven Shavell, Punitive Damages: An Economic Analysis, 111 Harv. L. Rev. 869, 873-74 (1998)

[34] Cf. Michael H. Cohen, "Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort." 73 Cal. L. Rev. 1291(1985); E. Allan. Farnsworth, Developments in Contract Law During the 1980's: The Top Ten, 41 Case W. Res. L. Rev. 203 (1990); Alan O. Sykes, Bad Faith Breach Of Contract By First-Party Insurers, 25 J. Legal Stud. 405 (1996).

monitor the progress of performance, to invest in relation-specific assets, to undertake precautions against risk, to acquire and share information, and to spend time searching for contractual partners and choosing those one's partners carefully. And they determine the allocation of risk and liquidity. A remedial term that promotes efficiency along one of these dimensions may sacrifice efficiency along another.[35] The optimal tradeoff will depend on the relative importance of these various factors to the particular parties involved. For this reason, the law of contract properly allows parties considerable (though not unlimited) leeway in choosing the damages that will flow from breach. To the extent that the interference tort is conceived as a supplement to contractual liability, the same principles of freedom of contract should apply.

4. Contracting over tortious interference

With the foregoing background, we are now in a position to frame the law of tortious interference in transactional terms. The analysis is analogous to the account of efficient breach with which we began, except we are now dealing with three parties instead of two; and two potential contracts instead of one.

Consider the example of a corporate raider deciding which of two target companies to acquire. The companies are equally attractive targets from a business standpoint, but the legal hurdles to acquiring them are different. Specifically, the first company, Target 1, has provisions in its charter (or is incorporated in a jurisdiction) that disable its management from alienating the power to shop all takeover offers until they are consummated in a final deal. (Put aside for the moment how such provisions might be implemented and enforced; suppose that such a transaction

[35] For example, full expectation damages will if properly measured provide promisors with optimal incentives for performance and for investing in precautions to ensure that performance is possible. At the same time, however, they will provide inadequate incentives for promises to take precaution against the possibility of breach, inadequate incentive to search for the correct contractual partner, excessive incentive to invest in reliance activities, and either inadequate or excessive incentive to acquire and share info about the object of exchange. They also may require a risk-averse promisor to bear an inefficiently high level or risk. See Steven Shavell, Damage measures for breach of contract, 11 Bell Journal of Economics 466 (1980); Steven Shavell, The design of contracts and remedies for breach, 99 Quarterly Journal of Economics 121 (1984); Benjamin Hermalin, Avery W. Katz, and Richard B. Craswell, Contract Law, in the Handbook of Law and Economics, ed. Steven Shavell and A. Mitchell Polinsky (2007), pp. 102-114.

would be voidable by the target as ultra vires and that the acquirer knows it.)[36] These provisions do not prevent Target from entering into a binding contract that would pay breakup fees to Acquirer in the event the deal does not come off, however; they only prevent Target from entering into a binding contract that lacks a termination option.

The second company, Target 2, has no such restrictions on its management's power to accept a takeover bid. The business press is following the merger talks and reporting on them, so all informed market actors know that the acquirer is interested.

If the acquirer enters into a letter of intent with Target 2, it knows that no other competitor can horn in on its deal without risking tortious interference liability. If the target signs with a competitor, the acquirer can expect to receive both expectation damages and tort damages. In order for a competitor to induce breach, accordingly, the competitor and target must together expect to earn surplus from the deal sufficient to cover both tort damages and expectation damages.

Entering into a letter of intent with Target 1 is riskier for the acquirer. If it is outbid by a subsequent competitor, it will receive its agreed-on breakup fees, but such fees are limited to a reasonable estimate of lost expectation under standard doctrinal restrictions on liquidated damages, and it will not be able to receive any punitive damages in tort. Accordingly, a competitor will be able to induce breach if it can offer a deal that expects to earn surplus sufficient to cover the acquirer's lost expectation.

Accordingly the maximum price that the acquirer will pay to sign a letter of intent to acquire Target 1 is less than the maximum price it will pay to sign a letter of intent to acquire Target 2. If it signs with Target 1, it will either receive its expectation from the merger, or the breakup fees as compensation. If it signs with Target 2, however, it stands a chance of receiving larger damages in tort. Its expected return is thus higher and so it will be more eager to enter into a deal.

[36] One method would be to include a term in the letter of intent under which Acquirer consents to Target's merger with Competitor, on condition of Target giving notice and paying the promised breakup fees. Such advance consent would eliminate Acquirer's right to sue for tortious interference. See Restatement (Second) of Torts §§ 767. Another method would be for Acquirer and Target to promise each other not to assert claims of interference against third parties; this method would not eliminate Acquirer's power to sue but would make it a breach of the underlying contract, entitling Target to recover any losses it suffered from Acquirer suing Competitor (including losses incurred under an indemnification agreement).

The fact that Acquirer is willing to pay more to enter a deal with Target 2, however, does not necessary imply that Target 2 is better off than Target 1, because Target 2 gives up the option to terminate and go with a better tender offer from Competitor. Whether the higher price is worth giving up the option to terminate depends on a balance of factors discussed in the later part of the paper. And the same factors determine whether a company choosing its charter provisions or deciding which jurisdiction in which to incorporate, will be better off emulating Target 1 or Target 2. Different companies will find it in their interest to make different choices.

The key aspect of this hypothetical is that tortious interference takes the form of competition: the defendant enters [or attempts to enter into] contractual relations with a target who is the plaintiff's existing contractual partner. Compare the hypothetical with another type of tortious interference in which the interferer does not anticipate any prospect of a contractual relationship with the target (for instance, when the interferer is simply trying to drive the plaintiff out of business for malicious reasons, or induces the target to breach in the course of engaging in some other wrongful or negligent behavior). In the absence of contractual privity, neither the acquirer nor the target would have any interest in giving up their right to sue for interference. Doing so would simply increase the chance of being interfered with. The result might be a countervailing gain to the interferer, but without contractual linkage there is no possibility of any of this gain coming to the original parties.

The logic of the example extends to any situation in which an original contracting party and a future entrant are linked through a common counterparty in a chain of privity. The reasoning goes as follows: in the final stage of contracting, when the entrant arrives and begins bargaining with the counterparty, the prospect of tort liability will affect the entrant's reservation price in any deal struck with the counterparty, reducing the potential surplus to be gained. The risk of tort liability can be allocated between the counterparty and the entrant according to their relative willingness to bear risk; a counterparty who is completely risk averse can get a better price by promising to indemnify the entrant for any damages that must be paid to the original party, or vice versa. But either way. the prospect of tort liability will reduce the counterparty's expected profit from dealing with the entrant.

The prospect of lower expected profit at stage 2, however, reduces the counterparty's reservation price for a deal with the original party at stage 1. As a result, the original party pays a certain premium up front in order to get uncertain tort payments at the back end. Whether it is worth paying the premium depends upon what the tort payments are worth in terms of improved incentives across all margins relevant to the parties. In this regard, all of the factors identified by the existing literature are relevant: potential inadequacy of expectation, the desire for supracompensatory damages as a signaling or bonding device or to encourage relational investment, the desire for a third party guarantor to insure against promisor insolvency and to monitor against promisor misbehavior, and the like. But none of these factors are free, and some parties will prefer to choose a weaker set of rights and remedies in exchange for a lower price.

5. [Extensions — to be completed in subsequent draft]

[A. Alternate configurations for contractual interference]

[In the discussion of the previous section the aggrieved party (Acquirer) and the interferer (Competitor) never deal with one another directly, but other configurations are possible. One common configuration arises when two parties who are linked in a chain of contractual privity through a common counterparty collude to cut the counterparty out of the deal and convert his expectation gains to their own use. Real estate brokers are particularly vulnerable to such collusion, since the effort they invest in assisting in the house is highly relationship-specific and the product of the effort takes the form of information that is relatively easy to expropriate. A typical broker invests in information about the local market, advises the owner on the terms of the listing, and searches for potential buyers. Typically such brokers are compensated by paying them a commission that takes the form of a percentage of the purchase price. The incentives created by this arrangement are not perfect; in particular, the broker has suboptimal incentives to invest in sales effort after having locked the homeowner into an exclusive listing agreement, because optimal effort would require the broker to invest an additional hour of her time whenever the hour would produce an expected gain in sales price equal to or greater than her implicit wage rate. However, because the broker receives only a fraction of the gains from a higher sales price, her private incentive is to invest in effort only if the expected gain in sales price is equal to the broker's wage rate divided by her commission rate.[37] The

[37] For instance, if the broker's implicit wage rate is $100 and her commission is 5%, then (subject to reputational factors) the broker will only want to put in an extra hour of time if the average result would at least a $2000 increase in the sales price; the extra $2000 multiplied by the 5% commission yields the broker just enough return to compensate her for the value of her time. But from the collective point of view of seller and broker

outcome is second-best, however, because the seller is not otherwise able to observe the broker's effort level and so is unwilling to pay a flat fee; the commission is needed to induce the broker to put in any effort at all.[38]

[One problem with this arrangement is that once the broker produces a buyer, the seller's incentive to pay the sales commission is substantially diminished. If the seller and potential buyer are able to communicate directly, they have an incentive to refuse to go through with the deal, and then meet up behind the broker's back and complete the transaction on their own without paying the commission. Under the Restatement, a claim of tortious interference would lie.[39] But whether the broker wishes to reserve the right to receive interference damages depends upon what it costs him in terms of reduced flexibility for the buyers and sellers he deals with. The value of tort liability must also be compared with other assurance mechanisms than can be achieved via the basic agency contract: for instance, by providing for an exclusive agency; by adding a term under which the broker receives a commission on any sale made by the seller whether or not it is to a buyer procured by the broker; or entering into an agency contract with the buyer as well as the seller. All of these arrangements are in use in real estate brokerage markets and it is not obvious that they are inferior to tort liability in protecting the parties' collective interests. The answer will depend on the relative importance of the various behaviors that the parties wish to motivate, and the various risks they wish to allocate among themselves. As in the case of the corporate raider, however, a legal regime that allows the parties to recontract around interference liability may improve their ability to enter into contracts that are most efficient from their individual perspectives.]

[B. Implementation through specific transactional devices]

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together, it is worth spending up to just under 20 hours of additional time to achieve a $2000 increase in sales price.

[38] [Citation to be provided – standard principal /agent analysis. Cf. contingent fees for lawyers.]

[39] As in Myers v. Arcadio, 73 N.J. Super. 493) (1962), in which a real estate broker working under a nonexclusive agency contract produced a prospective buyer who was interested in the house. Instead of buying the house through the broker and paying a commission, the buyer arranged for a friend to contract directly with the seller to buy the house and then transfer the purchase contract to the interested buyer. Because the buyer had no contractual relationship with the broker and because the seller was not privy to the scheme, the broker had no recourse to the implied duty of good faith. A claim of fraud might have been possible but would have been difficult to prove by clear and convincing evidence. But the broker managed to recover from the ultimate buyer on the theory that the buyer had interfered with the broker's contractual relationship with the seller.

In the original contract:

- Negative pledges
- Breakup fees
- Non compete clauses
- Performance bonds
- Secured credit
- Staking a claim through private registering, escrow, or control transactions

In the subsequent contract:

- Indemnification clauses
- Warranties of good title
- Recognize private registries

[C: Third party effects

- Rent extraction from the entrant [as in industrial organization literature on liquidated damages as barriers to entry: Aghion/Bolton, Chung, Spier/Whinston]
- Non-adjusting creditors [as in literature on the efficiency of secured credit].

[D. Caveats and frictions in the case law]

- Cases denying tort liability where original parties liquidate damages
- Cases imposing enhanced liability in response to indemnification clauses [e.g., Pennzoil v Texaco]
- Unforeseen opportunism and the problem of bad faith

6. Conclusion

The parties' ability to contract over liability for contractual interference, and to provide contractual substitutes for such liability, changes the standard analysis of the tort in at least three ways. First, it affects the expected incidence of any remedy that is awarded. A party whose contractual rights are enhanced by the prospect of a tort claim against a third party interferer will often themselves paying for such extra protection up front, because interference liability will reduce the counterparty's flexibility in the event that a better opportunity comes along. Second, it undermines the argument that liability for tortious interference is needed to make up for gaps in the initial contract or for the risk that a breacher will be insolvent.

The first two factors might be read to suggest that the existence of the interference tort reduces contracting parties ex ante welfare. But there is a third, countervailing factor. Tortious interference liability, by providing a method for an aggrieved party to recover from an entity in contractual privity with the breacher, allows the parties to indirectly impose supracompensatory damages on each other. Since the law of contracts typically does not allow the the parties to contract into supracompensatory damages directly, the tort option enhances their freedom of contract.