

# The Morality of Breaching, Efficiently

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## 1 Introduction

“Better break your word than do worse in keeping it.”<sup>1</sup> The suggestion is particularly compelling when breaking the promise leaves no one worse off, while keeping it is strictly worse for any or all parties. What is the point of performing such a promise when it can be avoided? Granted, dynamic considerations may call for credible commitments to carry out promises that are inconvenient to all concerned, but commonsense surely favors avoidance of those obligations that serve no purpose other than fulfilling themselves. Often, of course, these obligations are not just naked promises—they are also legally enforceable, but that does not alter the basic point.

Two things are accomplished when someone, in appropriate circumstances, makes a contract promise. She makes a promise, and she makes a contract. Should

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she choose, without the promisees consent, to abandon the contract promise in order to pursue an *objectively* superior course, the promisor would break both the promise and the contract. My immediate concern is the latter: the breaching of contracts better broken than kept. Conceding the value in avoiding performance of these contracts, what practical and normative stance should law adopt with respect to their breaches?

To insist, always, on performance notwithstanding the value of its avoidance would confound commonsense and this is nowhere the law. Some say that law does, or should, give a nod toward breach when expectation damages are known to follow.<sup>2</sup> The fact that breach followed by expectation damages theoretically precludes futile performances certainly recommends it. But, this recommendation gives no normative priority, either in terms of economic efficiency or morality, to breach and expectation damages over an infinite set of remedial options that also precludes this futility. The efficiency claim, which applies to allocation, investment and search, among other economic considerations, is presented in the appendix. The morality claim is the immediate challenge for this essay.

Morality too allows options when it comes to promoting social welfare, including efficient breach. This is an important point, too often obscured in the debate. Promisors are neither morally required to breach when doing so would increase social welfare, nor are they morally prohibited from breaching in cases where the cost of performance outweighs its value. The first claim is noncontroversial in the legal

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<sup>2</sup>See e.g., Judge Posners opinion in *Patton v. Mid-Continent Systems, Inc.*, 841 F.2d 742,750 (1988), observing that “the law doesn’t want to deterred efficient breach. The full quote follows: “Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee’s actual losses. If he is forced to pay more than that, an efficient breach may be deterred, and *the law* doesn’t want to bring about such a result. *Id.* (emphasis added). [add other cites].

debate, though not obviously so. Why shouldn't a promisor be morally required to breach if doing so can lead to greater social welfare without harm to the promisee or promisor? Why not, a moral duty to breach, efficiently? <sup>3</sup>

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<sup>3</sup>Whatever the merits of such a requirement, it suffices to say that individuals are typically not required by law or morality to take actions that lead to greater social welfare. *See e.g.*, Shelly Kagan, *The Limits of Morality* (Oxford: Clarendon Press, 1989, at 204), presenting a compelling case to expand the scope where “[a]n agent is morally required to perform that act which can be reasonably expected to lead to the best consequences overall. *See also*, Shelly Kagan, “Defending Options, 104 *Ethics* 333 (1994); Michael E. Bratman, “Kagan on ‘The Appeal to Cost, 104 *Ethics* 325 (1994); Jeremy Waldron, “Kagan on Requirements: Mill on Sanctions, 104 *Ethics* 310 (1994). Individuals have options, within bounds, to sacrifice social welfare for self-interested reasons. Consideration of the costs to oneself of keeping a promise may also morally permit breach, particularly where those costs greatly out-weigh the promisees benefit from the promise. (Morally, a promise does not bind a promisor to a course of conduct absolutely. “It does not bind absolutely, because, while a promise binds one against reconsidering ones intention simply on grounds of ones own convenience, it does not bind one to do the thing promised whatever the costs to oneself and others. T.M. Scanlon, *What We Owe to Each Other*, (The Belknap Press of Harvard Univ. Press, 1989, at 309). Contract laws excuse doctrines most obviously reflect this intuition, but it is found elsewhere as well.) Given the moral permissibility to act in spite of, and in pursuit of, social welfare, what accounts for the intuitive resistance to efficient breach? I suggest that the resistance is largely informed by a sense that efficient breach runs afoul of what I shall call a partys participation interest. When this interest is satisfied, the morally optional and permissible nature of efficient breach realigns with the general sentiment that otherwise resists it.

It would take the rest of this writing to adequately describe what, exactly, I mean by the participation interest, and that, I'm afraid, would still not be enough (due to the writer, not the reader, of course). As a point of departure, however, let me identify two meanings I definitely do not intend. First, the participation interest is not a right to control the course of performance or a right to control the promisor. Second, the participation interest is not a right to share in the gains from efficient breach, although such sharing may be good evidence that the participation interest is satisfied. A participation interest is a broad and general feature of every voluntary exchange, running through the entire course of the transaction from formation to completion or abandonment. That is not to say each party must participate at every moment or in every decision; rather, it implies only that a partys participation should be reflected in decisions that matter to her over the course of the contractual relationship even if that reflection merely indicates that she delegated to the other party authority over these decisions.

## 2 Morality of Efficient Breach

The moral argument for efficient breach, if one is to be made, must be a utilitarian one of some kind. Yet law and economics proponents of efficient breach have tended to steer clear of utilitarian arguments for the moral basis of the claim.<sup>4</sup> They have instead looked for morality in an imagined consent.<sup>5</sup> Steve Shavell has made the most recent argument justifying efficient breach in terms of a hypothetical consent. I will turn to that argument shortly and demonstrate that his hypothetical consent framework does not translate well to actual consent. Yet one could allow for actual consent (while staying within the narrow confines of the rationality framework that the efficient breach argument presupposes) without sacrificing the prized efficiency. Consent, however, is not the sole objection to efficient breach. Observers also resist the idea of the breacher gaining—enriching himself—from breaching. But this objection can be addressed too in the structure of the model.

When the promisor “does not gain,” but merely limits a loss by not performing a *losing contract*, even the staunchest critics of efficient breach would find that sort of efficient nonperformance unobjectionable.<sup>6</sup> One might imagine that the promisor and promisee in such a case would come to a mutual agreement to release the promisor from performing, so nonperformance would not constitute breach. If this is the case, then

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<sup>4</sup>The strongest advocate for the economic analysis of law would not appeal to utilitarianism. “Natural as the alliance would appear, Posner would have none of it,” observed Coleman, “and for the simple reason that he had been convinced by the classic objections to utilitarianism. Maximizing utility can often lead to injustice, sacrificing the one for the good of the many. Utilitarianism is a defective moral theory, an inappropriate standard on which to justify state coercion so Posner himself thought.” Jules L. Coleman, “The Grounds of Welfare,” 112 *Yale L. J.* 1511, 1516.

<sup>5</sup>“To find a moral foundation suitable to efficiency, Posner looked to a particular conception of Kantian moral theory one that emphasized the importance of individual autonomy as expressed in the capacity to consent.

<sup>6</sup>See Daniel Friedmann’s polemic retort to efficient breach, where he equates it with efficient theft. D. Friedmann, “The Efficient Breach Fallacy,” (1989) 18 *Journal of Legal Studies*, 1-24.

the efficient outcome will result (Coase, 1960). But assume the parties cannot engage in Coasean bargaining, which sometimes happens of course. Moreover, assume the seller realizes that the contract is a losing one for the buyer, who does not yet realize this fact,<sup>7</sup> yet the seller cannot credibly communicate the information to the buyer before performance is called for. In this case, would it be morally permissible for the seller to breach the contract for the benefit of the buyer? Let's say that the seller will receive the contract price in any event, and reputational or other concerns do not weigh on her to perform, might we say that the seller has a moral obligation to breach the contract for the benefit of the buyer?

One might object by saying that the seller may be mistaken about the facts or otherwise ought not make the decision, paternalistically, for the buyer. So assume that the buyer, following a breach by the seller, may always compel specific performance. Hence the only effect of the seller's breach is to avoid a wasteful performance if the buyer in fact is better off without it, but the buyer can after the fact decide to compel the performance. In this case, it seems senseless for the seller not to breach for the benefit of the buyer.

Alternatively, one might object by saying that the seller gets nothing from the breach and therefore would not breach. But that's not entirely satisfactory. First, we must acknowledge that the seller is indifferent to breach here: she gets exactly the contract price in either case. Moreover, why not impose a moral duty to rescue the buyer here. Individuals who cringe at the bad Samaritan who walks by a drowning man when he could easily throw a rope to the man in trouble should feel some unease in this case too. Yes perhaps the man was attempting suicide and a good Samaritan's paternalistic intervention would be officious. In the case of the Samaritan there is at

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<sup>7</sup>Seller's often have relatively greater insight about the expected value of performance—especially in the case of one-time purchases or emotionally-laden acquisitions where buyer's regret often follows—because of experience dealing with many buyers over time.

least some cost, however trivial, to rescuing the other party, but in the case of the promisee with the losing contract, there is, by assumption, no cost to the rescue. The promisor is left perfectly indifferent between breach and performance. So why not say that she, the promisor, has a moral duty to help the other party by not performing.

If you find any traction in the argument for losing contracts, then allow me to go a little further. Let's say that the promisee is perfectly indifferent between the promisor's performance and breach even before damages—that is, his value of the promisor's performance is exactly zero—but the promisor may generate a surplus by redirecting her efforts to another party. Here, of course, the standard objections to the conventional efficient breach argument apply: there is something undesirable about the promisor gaining a surplus from breaching and it is the promisee's privilege to release the promisor from her obligation to perform, rather than a self-executing right of the promisor. So let's disgorge the promisor of arbitrarily all the gain (and give the gain to the promisee or to charity) and let's have the promisee decide whether to compel the promisor performance after the fact. In this case, again, might we say that the efficient breach is morally permissible, if not morally required? I advance no argument here about the promisee's decision to compel performance at a cost to society. That is a separate question. My focus here is the promisor's breach.

Allowing further that the promisee's contract is not a losing one, nor is he strictly indifferent between performance and breach before compensation, but rather could be made indifferent or better-off with breach followed by compensation. In this context, the typical setting from which the conventional efficient breach hypothesis departs, can there be a case for morally permissive efficient breach? Again, matters of surplus division and legal rights to performance are significantly variable in this context too. Once concerns about the promisor's gaining "too much" of the surplus from breach and the promisee being denied his right to elect performance are

addressed, the grounds for objecting to efficient breach are substantially weakened. What's left then offers a utilitarian argument that I believe most people would find unobjectionable.

## 2.1 Non-Uniqueness Critique of Hypothetical Consent

Professor Shavell locates the question of whether breach is moral within an incomplete contracts framework.<sup>8</sup> From this framework, he argues, several issues become clear. First, if the contract expressly requires the promisor to keep the promise should an objectively better opportunity arise then breaching the contract is immoral. Second, if the contract expressly allows the promisor to pursue better opportunities when they arise, then there is no breach of contract, of course, let alone an immoral one. Hence, he concludes, hard questions about whether a breach of contract is immoral largely turn on scenarios involving contracts for which the parties have not expressly provided terms that anticipate the circumstances surrounding the breach.

To resolve these hard questions about the morality of breach, Professor Shavell undertakes a simple and insightful inquiry: he asks what would the parties have stipulated in the contract had this contingency been anticipated and addressed. Obviously, they would not have agreed to a term requiring the promisor to perform at all costs. Indeed, they would never require, in a fully stipulated contract, the promisor to perform when the cost of performance is greater than its value. Therefore, breach leading to nonperformance in these cases is consistent with the agreement concerning performance that the parties would have reached had they addressed the contingency in their contract. Accordingly, he establishes a criterion whereby breach is morally

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<sup>8</sup>See Steven Shavell, "Is Breach of Contract Immoral?," 56 *Emory L. J.* 439 (2006). See also, Louis Kaplow & Steven Shavell, *Fairness versus Welfare*, Harvard University Press, 2002; Kaplow, Louis & Steven Shavell, "Fairness versus Welfare," 114 *Harv. L. Rev.* 961 (2001).

permissible when the parties would have wanted nonperformance of the promise.

Moreover, Professor Shavell observes, when the remedy is expectation damages, breach by the promisor allows us to infer that the parties would have stipulated non-performance in the realized contingency. Why can this inference be drawn? “Because that is exactly when a seller would not have to perform in a completely detailed contract, the seller will fail to perform in the same contingencies as the seller would be permitted not to perform in a hypothetical complete contract. Accordingly, *breach should not be characterized as immoral when expectation damages are paid for breach.*”<sup>9</sup>

The argument is true as far as it goes: rational parties specifying terms for contingencies, *ex ante*, would not call for performance when its cost is greater than its value; they would have agreed to release the promisor from the obligation to perform in those cases. The efficient allocation is the one the parties would have agreed to and, therefore, one might say this outcome carries a certain moral force despite being brought about through breach. The allocative outcome associated with breach is normatively justified in terms of this moral screen (i.e., it is what the parties would have chosen). But what about the distributive outcome—the distribution of rents and the distribution of rights, who gets what and who gets to decide—associated with breach?

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<sup>9</sup>Steven Shavell, “Why Breach of Contract May Not be Immoral Given the Incompleteness of Contracts,” 107 Mich. L. Rev. 1569, 1574 (emphasis in original). Professor Shavell says “that if damages equal the buyers expectation, breach can be inferred to be moral because it will occur only when the parties would have allowed nonperformance in a complete contract.” [1574]. This means nonperformance is moral, according to the criterion set out by Professor Shavell. “However, when damages are less than expectation, we cannot make the inference and would have to inquire directly about the costs of performance relative to its value in order to make a judgment about its morality.” [1574-75] Yet, when damages are greater than expectation, the inference may still be drawn so long as they are less than the costs of performance.

How can we know that the parties would have struck any particular bargain over rights and rents, like allowing the promisor to elect between performing and paying expectation damages? Is it not plausible that a rational promisee would have wanted the promisor to come to her first to get her release or at least her participation in the allocation decision concerning the performance that she, promisee, was expecting? Notice also that the promisor captures all of the gain from nonperformance when the background remedy is expectation damages. The promisee is left indifferent between the state where the promisor elects to perform and the one where she elects to breach and pay expectation damages. Is this really what they would have bargained for had they anticipated the circumstances surrounding the would-be breach? Perhaps, but perhaps not.<sup>10</sup>

Yet, if we cannot say with confidence that the parties would have agreed to any

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<sup>10</sup>True, the American remedial norm is indifference, meaning courts are charged with requiring breachers to make breachees whole by putting them in an equivalent position or state as the non-breach position or state. [Cite Mel Eisenbergs Indifference article. Although, it is not entirely clear that the so-called remedial default is agreed upon by courts or commentators; Cf. Seigelman & Thel; Farnsworths Your Loss My Gain, &c.] That's the directive for courts; a directive which may, in fact, have evolved from some majoritarian impulse. But, why should we think that this particular directive would have guided the parties bargaining in the counterfactual world where they had they foreseen the circumstances surrounding the breach? Why wouldn't the promisee demand more than indifference given that she would be providing a contract term that allows the promisor the right to break the contract without the promisees prior consent or knowledge whenever it is in the promisor's individual interest to do so? (Recall, the promisee is indifferent between the exercise and nonexercise of the right by the promisor.) Of course, the promisor might compensate the promisee for this right by offering a lower price ex ante. In this way, the promisee participates in the gains from efficient breaches in expectation. When the parties anticipate contingencies where efficient breaches might occur, they could factor that into the price term of the original agreement. But recall, we began by assuming they neither anticipated the circumstances surrounding the breach nor did the terms of their agreement, including the price term, account for the circumstances. If the price term did account for such circumstances, it would not be a breach at all [the second category, sort of, that Professor Shavell described]; one would just need to properly interpret the meaning of the price term. The problem here, however, is not one of interpretation of an existing term, but the attempt to construct a non-existing term based on what we imagine the parties would have chosen. How can we know this? See Appendix, which describes a thought experiment suggesting indeterminacy from hypothetical bar-gaining.

particular assignment of rights and rents in the hypothetical state then the morality screen that Professor Shavell offers becomes a sieve. It lets through a large number of alternatives, all of which leading to same allocative outcome.<sup>11</sup>

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<sup>11</sup>Let  $\Delta$  be the social gain from nonperformance of inefficient contracts, that is,  $\Delta = [c(\sigma, \omega) - v(\beta, \omega)]^+$ . It is often suggested that offering the seller anything less would lead to inefficiencies, but that is not true. For example, the promisor's share of the gains from efficient nonperformance may be represented by  $\frac{1}{N} \cdot \Delta$ , where  $N \in \{1, 2, 3, \dots\}$ . In this case, the promisor gets the entire gain when  $N = 1$ , which is equivalent to the expectation remedy, leading the promisor to breach efficiently. Yet a she also breaches efficiently when  $N = 2$  even though she gets only half the gain, and when  $N = 3$  where she gets a third of the gain, and so on. This sequence may fairly represent the default division of the surplus for breach of contracts within  $N$ -party partnerships and joint ventures. (*See e.g.*, Meinhard v. Salmon and other cases.) As  $N$  approaches infinity the promisor's share of the gain approaches zero and the remedy becomes arbitrarily indistinguishable from the conventional disgorgement remedy commonly issued for breach of the duty of loyalty by fiduciaries. Still, at the margin, the hyper-rational promisor assumed in the conventional models will breach efficiently. One might argue that her investment incentives, already inefficient under expectation damages will be further degraded under a disgorgement like remedy. However, not that the buyer's incentive to overinvest in weaken under this remedy.

Which  $N$  would parties select if they had imagined the ex ante the contingency that leads a situation where breach is efficient. Observe that when Professor Shavell states the expectation breach followed by expectation damages is the remedy that parties would have chosen, he is in effect saying that  $N = 1$  is the unique choice of parties. He says this is so because it leads to nonperformance in exactly those where the parties would have selected nonperformance in a fully specified contract. Yet any  $N$  from 1 to infinity would produce this result. Would partners or joint venturers choose  $N = 1$ , would principals select that denominator for breaches committed by fiduciaries? Would two ordinary contracting partners, like the prototypical buyer and seller, choose  $N = 1$  as opposed to  $N = 2$  or something very near it division?

Without assuming more, such as, it was the sellers effort and investigation that lead to the realization of the efficient breach opportunity, and if one were to disgorge from her ex post the gains of breach she would not have incentive ex ante to find these socially useful opportunities. It is not hard to imagine the parties agreeing that if the seller should invest her resources in finding value enhancing opportunities that leave the buyer no worse off, then she should be rewarded for her investments with some or all of the gains from the efficient breach. Investment efficiency would require that result, not to mention fairness. However, but what about cases where the seller make no marginal investment in identifying the better opportunity? Would efficiency or fairness recommend that she captures the gains from her efficient breach? It is hard to imagine that the parties, in a situation where the seller stands to profit from a breach that was not anticipated (and therefore not incorporated in the contract price) and into which she invested no resources, that the buyer would agree to give all of the gains to the seller. When a seller gains as such, with indifference to the initial agreement, the buyer may feel that the the seller is not behaving fairly. It is not the the buyer necessarily wants all or half of the gain, or even that she wants specific performance. Rather the buyer may feel that the seller has violated a basic dignity or fairness taboo in her treatment.

Thus we cannot say, as he does, that breach should not be characterized as immoral when expectation damages are paid for breach because it reflects what the parties would have chosen in the fully specified contract.<sup>12</sup> Nor can we say, as others claim, that breach should be characterized as immoral even when expectation damages are paid for breach. Lets now turn to Seana Shiffrins argument for this claim, as it will shed light on the participation interest.

## 2.2 Critique of Involuntary Employee Argument

To tease out the normative problem with Professor Shavell’s efficient breach argument Professor Shiffrin asks her readers to imagine themselves as homeowners contracting with a plumber, who neither shows up as agreed nor calls, but instead allows the homeowner to sit around waiting all day for a service visit that does not occur.<sup>13</sup> No doubt many people, probably most, would resent being treated in that fashion. “If the no-show plumber were to appear next time matter-of-factly presenting you with a check or a discount reflecting the value of your time that was wasted I suspect,” she says, “that, after emerging from shock, the resentment would not fully dissipate.”<sup>14</sup>

In relating this persistence of resentment to the general resistance that appears to confront efficient breach Professor Shiffrin suggests a common problem. “When the plumber opts not to show (without consulting with you to gain your permission or waiver) because another job is more urgent or unfinished or pays better, even if we indulge the fantasy that the plumber would compensate you for your time and

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<sup>12</sup>Breach causing nonperformance captures only one aspect of what the parties would have agreed to and multiple other rules can also bring this about.

<sup>13</sup>Both Professors Shavell and Shiffrin rely on personal service contracts—for snow removal and plumbing services, respectively—to illustrate their claims concerning the (im)morality of efficient breach. Whether, and to what extent, the intuitions they offer change when goods are exchanged between agents in market-based transactions are questions worth asking, but not pursued here.

<sup>14</sup>Seana Shiffrin, “Could Breach of Contract Be Immoral?,” 107 Mich. L. Rev. 1551, 1564.

irritation, she has still made a decision for you about how your time, attention, and labor must be devoted.” To drive home the point, Professor Shiffrin presses, by breaching the plumber “has made you an involuntary employee of hers. She has usurped your ability to make independent, involuntary decisions about the use and form of your time, attention, and labor.”

For Professor Shiffrin, the problem with efficient breach is that it involuntarily alters the activities one must perform. But this claims too much. It recognizes a simple fact of human interdependency, with or without breach of contract. If the plumber had diligently showed up a bit earlier and a lot worked later than expected, without charging more, those actions too would alter the activities, involuntarily, of the homeowner. The underlying problem, I offer, is not one of usurpation of the homeowners time, attention and labor, but rather a disregard of the homeowners interest in participating in the decision by the plumber to allocate, for some other purpose, the time the plumber had agreed to spend working for the homeowner. The problem, I think, concerns the reallocation of the plumber’s time, attention, and labor—not the homeowner’s *per se*.

The agreement between the homeowner and the plumber grants the homeowner some entitlement over the plumbers activities during the stipulated period. I am not suggesting that the homeowner has a right to fully command the plumbers activities in this period (i.e., there is no claim here that the homeowner has a right to any specific performances). Nevertheless, if the plumber seeks to redirect her time, attention and labor away from the homeowners job, then I maintain that the homeowner has an interest, however small,<sup>15</sup> in participating in the decision. When the

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<sup>15</sup>The homeowners resentment may manifest even if her participation interest is small, and sometimes precisely because it is small. Say that a simple notification (a call, email or text message) was all the homeowner sought in the decision by the plumber to not show-up—notification not so that the homeowner could plan her day differently, but just out of courtesy given the relationship and agreement between the parties—then a failure to undertake this trivial act of courtesy may cause

plumber disregards this interest, then her efficient breach runs counter to the commonsense morality of options, within bounds, that allows individuals to pursue or ignore efficiency (or, in other words, social welfare).

### 2.3 A Participation Interest?

When parties anticipate contingencies where breach is efficient and factor them into the written terms of their agreement or reflect them explicitly in the price term or, more controversially, if they get reflected in the price implicitly,<sup>16</sup> then we may conclude that the parties both participate in the determination of the efficient breach outcome, i.e., they agree together beforehand that the promisor neednt perform the promise in these contingencies. If they actually did so, then the parties participation interest in the breach is satisfied. The lower price that the promisee was offered, and that she accepted, to release the promisor of the obligation to perform in these contingencies is evidence of her participation in the determination of “breach.” Under these circumstances, nonperformance (breach seems a misnomer in this context) and payment of expectation damages would be entirely consistent with the promisees participation interest: the promisee has participated in the decision to release the promisor of his obligation to perform in the contingency at hand, and that participation is reflected in the expressed terms or through some ex ante pricing mechanism.

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more resentment than an omission requiring greater effort from the plumber.

<sup>16</sup>Even if their particular agreement failed to anticipate the circumstances surrounding breach, it may still be the case that market structures which conditioned the negotiations and the price reached by the parties have accounted for these circumstances, in which we might say that the parties werent active/direct participants in the release, but they were participants indirectly through their participation in the market. There are reasons to resist this final interpretation. As Seana Shiffrin observes regarding “market pressures [that] force a price calibration[;] whether the ex ante price sufficiently compensates for the potential of deliberate breach depends in part on whether a mere implicit price break could morally compensate for a nonconsensual deliberate breach. This is, in part, what is at issue.” Seana Shiffrin, “Could Breach of Contract Be Immoral?” 107 Mich. L. Rev. 1551, 1558, fn. 27.

Now, assume that the parties did not directly anticipate contingencies leading to the cost of the promise exceeding its value. Imagine also that market structures did not account for these contingencies in the price term. The promisee, in this case, cannot be said to have participated in releasing the promisor of his obligation to keep the promise. Her participation interest is not satisfied—yet. Moreover, if the promisor breaches without the participation of the promisee, then the interest can never be satisfied in this case. This would render the moral permissibility of the breach dubious, even if it is efficient to breach and expectation damages are fully compensatory.

### **2.3.1 A Thought Experiment**

Even if the promisee placed no value on her interest in participating in the release of the promisor's obligation to perform, might she still demand more than nothing to allow the promisor to self-execute his own release? Imagine that a third party offering the better opportunity to the promisor creates a quasi-Ultimatum game. In the conventional Ultimatum game, a third party (an experimenter) offers two players a sum of money, say one hundred one dollar bills, which the two players can share between themselves only if they can agree on a division of the money. The rules of the game stipulate that one player, the proposer, proposes a division of the hundred dollars, and the other player can either accept the share offered by the proposer or reject it, in which case both end up with nothing. The game is played only once for one round. The economically rational outcome would be for the proposer to offer \$1 and keep \$99 for herself. The other party is better-off accepting the miserly offer of \$1 than getting nothing, which is what would happen if she rejects.

Now imagine some third party approaches a contractual pair and offers them

a sum of money beyond the total gains of their present contractual arrangement, but the offer requires that the parties agree to some division of this net gain. To what division would the parties agree? Let's say that their bargaining is structured as it is in the conventional Ultimatum game: the promisor (the proposer) has a single opportunity to offer some division, which the promisee can either accept or reject. If the offer is accepted by the promisee, the promisor is released from his prior obligation and the goods are delivered to the third party, allowing the original contract pair to realize a net gain beyond their contract—a gain which is allotted according the parties proposed and accepted division. However, if the promisor's offer is rejected, the opportunity presented by the third party is lost forever. What if the promisor proposed to give the promisee \$0 of the net gain, offering merely to bring her to the position she would have experienced had the fortuitous interloper not put the greater sum of money before them? That offer would probably be rejected as such low-ball offers usually are rejected in the conventional Ultimatum game. Yet, this division is exactly the one suggested by the efficient breach hypothesis. What would the parties have agreed to had they anticipated the interloper's opportunity and incorporated that contingency in their contract? We might imagine that the promisee would reject the offer (at least 50% of the time, reflecting her indifference between accepting and rejecting it) and receive specific performance or expectation damages, whichever remedial default is appropriate to the case. But, who's to say the structure of counterfactual bargaining around unanticipated efficient breaches would look like the Ultimatum exercise? No one knows. Still, it is not at all obvious that other bargaining environments, such as repeated rounds, would lead to an outcome where the promisee gets none of the gains from the promisor's release and subsequent enrichment. And, if it is not obvious that the parties would have agreed to this division, then the articulated basis for claiming that the promisor's decision to breach and pay expectation damages is not immoral goes away.



and the efficiency results are addressed. Fourth, additional remedies are considered.

## B Analysis

Given the setup above, the final payoffs to the buyer and seller are

$$\begin{aligned}\pi^B &= v(\beta, \omega) - \hat{p} - \beta \\ \pi^S &= \hat{p} - c(\sigma, \omega) - \sigma.\end{aligned}$$

First-best efficiency requires,  
(i) that the parties exchange the good only if

$$v(\beta, \omega) \geq c(\sigma, \omega) \quad \text{and} \tag{1}$$

(ii) that the buyer invests  $\beta^*$  and the seller invests  $\sigma^*$ , where

$$\beta^*, \sigma^* \equiv \operatorname{argmax}_{\beta, \sigma} \int_{\{\omega | v(\cdot) \geq c(\cdot)\}} [v(\beta, \omega) - c(\sigma, \omega)] dF(\omega) - \beta - \sigma. \tag{2}$$

### B.1 Expectancy Measured Against the First-best

When the remedy available for breach is expectation damages, the court orders the seller to pay the buyer an amount  $v(\beta, \omega)$ , which leads both parties to overinvest, but results in allocative efficiency. Allocative efficiency results because the seller, anticipating the court's order, will choose to perform when the buyer's value is greater than her costs. That is,  $S$  will perform whenever her payoff from completing the contract (i.e.,  $\hat{p} - c(\sigma, \omega)$ ) is greater than what she gets from breaching (i.e.,  $\hat{p} - v(\beta, \omega)$ )

$$\begin{aligned}\hat{p} - c(\sigma, \omega) &\geq \hat{p} - v(\beta, \omega) \\ v(\beta, \omega) &\geq c(\sigma, \omega).\end{aligned} \tag{3}$$

The buyer's overinvest can be seen in the expression below, where  $\beta^\epsilon$  represents the buyer's investment under expectation damages.

$$\beta^\epsilon \equiv \operatorname{argmax}_{\beta} \underbrace{\int_{\{\omega|v \geq c\}} v(\beta, \omega) dF(\omega)}_{\text{seller performs}} + \underbrace{\int_{\{\omega|v < c\}} v(\beta, \omega) dF(\omega) - \beta}_{\text{buyer gets damages}} \quad (4)$$

The first term of expression 6 shows the buyer getting valuation from the seller's performance and the second terms shows the buyer getting an equivalent value from expectation damages. Hence the buyer gets  $(v(\beta, \omega))$  in all states of the work and invest with that expectation:

$$\beta^\epsilon \equiv \operatorname{argmax}_{\beta} \int_{\Omega} v(\beta, \omega) dF(\omega) - \beta, \quad (5)$$

which implies to overinvestment by the buyer. Finally, because  $B$  overinvests,  $S$  will have to perform in more states of the world than she would under first-best efficiency (i.e., where  $v(\beta^*, \omega) \geq c(\sigma^*, \omega)$ ). That is, because  $S$  performs whenever performance is efficient, and  $B$ 's overinvestment causes performance to be ex post efficient more often,  $S$  will invest  $\sigma^\epsilon$  to minimize costs under this condition:

$$\sigma^\epsilon \equiv \operatorname{argmax}_{\sigma} \int_{\{\omega|v(\beta^\epsilon, \omega) \geq c(\cdot)\}} -c(\sigma, \omega) dF(\omega) - \sigma, \quad (6)$$

which means she will overinvest since  $v(\beta^\epsilon, \omega) \geq v(\beta^*, \omega)$

## B.2 Distributing of the Social Gain from Nonperformance

Recall the discussion from the text, where  $\Delta$  is defined as the social gain from non-performance of inefficient contracts, that is,  $\Delta = [c(\sigma, \omega) - v(\beta, \omega)]^+$ . Assume that the promisee gets  $\Delta - \epsilon$  of the nonperformance surplus while the promisor get's  $\epsilon$ .

### B.2.1 Disgorgement- $\varepsilon$ Measured Against the First-best

Let  $\varepsilon \rightarrow 0$  such that for any positive real number,  $\delta$ , it is the case that  $\varepsilon > 0$  is strictly less than  $\delta$ . This remedy is indistinguishable from disgorgement, and I will refer to it hereafter simply as disgorgement, rather than the more cumbersome Disgorgement- $\varepsilon$ .<sup>19</sup>

When the remedy available for breach is disgorgement, the court orders the seller to pay the buyer an amount  $c(\sigma, \omega)$ , which leads both parties to overinvest, but results in allocative efficiency. Allocative efficiency results because the seller, anticipating the court's order, will choose to perform when the buyer's value is greater than her costs. That is,  $S$  performs when and only when her payoff from completing the contract is greater than what she gets from breaching

$$\begin{aligned} \hat{p} - c(\sigma, \omega) &\geq \hat{p} - c(\sigma, \omega) - \varepsilon \\ \varepsilon &\leq 0. \end{aligned} \tag{7}$$

Yet when  $\varepsilon > 0$ , which occurs only when breach is efficient, the seller breaches.

The seller's overinvest can be seen in the expression below, where  $\sigma^\delta$  represents the seller's investment under the disgorgement remedy.

$$\sigma^\delta \equiv \operatorname{argmax}_\sigma \underbrace{\int_{\{\omega|v \geq c\}} -c(\sigma, \omega) dF(\omega)}_{\text{seller performs}} + \underbrace{\int_{\{\omega|v < c\}} \varepsilon - c(\sigma, \omega) dF(\omega)}_{\text{buyer gets disgorgement}} - \sigma. \tag{8}$$

The seller incurs a cost of  $c$  in every state of the world and therefore overinvest, relative to the first-best. On the other hand, however, observe that the buyer's investment is improve compared to that which results under expectation damages. The buyer's invest can be seen in the expression below, where  $\beta^\delta$  represents the buyer's investment under disgorgement.

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<sup>19</sup>I recognize that this usage is contestable, but I would like to defer the contestation for the moment to work through the model a bit more first.

$$\beta^\delta \equiv \operatorname{argmax}_\beta \underbrace{\int_{\{\omega|v \geq c\}} v(\beta, \omega) dF(\omega)}_{\text{seller performs}} + \underbrace{\int_{\{\omega|v < c\}} [c(\sigma, \omega) - \varepsilon] dF(\omega) - \beta}_{\text{buyer gets disgorgement}} \quad (9)$$

Because the buyer's damages under disgorgement are not a function of her investment,  $\beta$ , the buyer does not overinvest to ramp up the damages she collects. Yet, because the seller overinvests under disgorgement,  $S$  will have to perform in more states of the world than she would under first-best efficiency (i.e., where  $v(\beta^*, \omega) \geq c(\sigma^*, \omega)$ ). Hence the buyer will invest more (because performance occurs more often) than in the first-best state of the world.

### B.2.2 Expectation- $\varepsilon$ Measured Against the First-best

Now let  $[\Delta - \varepsilon] \rightarrow 0$  such that for any positive real number,  $\delta$ , it is the case that  $\Delta - \varepsilon > 0$  is strictly less than  $\delta$ . This sharing of the social gain from is indistinguishable from the expectation damages remedy in terms of allocation and investment efficiency.

### B.3 Distributing the Rights of Nonperformance

Any division of  $\Delta$  such that  $\varepsilon > 0$ , however small, is consistent with rational actors breaching when breach is efficient and avoidance of inefficient performance whether the promisee has an absolute right to performance or not.